Interim Report on Focused Audit of NUI Corporation and its Affiliates Docket No. GA03030213

Presented to the:

Division of Audits
New Jersey Board of Public Utilities

By:

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December 17, 2003

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I. Introduction

A. Audit Description

The New Jersey Board of Public Utilities (BPU or NJBPU) selected The Liberty Consulting Group (Liberty) to conduct a Focused Audit of NUI Corporation (NUI, NUI Corp., or the Company) and its subsidiaries. Work began in June 2003 and the audit is continuing. The BPU has asked Liberty to provide a report at this juncture, recognizing that significant events occurring at NUI in the past several months have extended the field work of the audit, while other events make it appropriate for a public report now on what Liberty has found and concluded to date. This interim report presents Liberty's description of key events and activities, findings, and conclusions to date. Liberty continues to work on a much more extensive report that provides much of the underlying data and analyses that support the findings and conclusions of this interim report.

The audit scope as initially proposed included the examination of:

- Issues that affect the quality of the companies' internal financial controls, financial integrity, and corporate accountability
- Concerns about causes of poor performance of investments outside NUI's utility expertise and their possible effects upon Elizabethtown Gas Company (ETG)
- Whether adequate separation has existed between the utility and the holding company for the purpose of ensuring that ETG is insulated, so that its customers have not been exposed to any of the consequences of NUI's non-utility holding company relationships and activities
- Whether there have been any inappropriate activities, such as commingling of funds, improper sharing of utility resources, or over-reliance on the utility to support the parent's condition
- Whether ETG's financial integrity is compromised by NUI Corp.'s diversification efforts or other actions, and if so, what action the Board should take
- The potential negative financial impacts on utility financial integrity and capital costs due to holding company diversification efforts and any lack of financial controls to protect the utility.

The specific focus areas established for this audit include:

- Corporate Governance
- Strategic Planning
- Financial Structure and Interaction
- Affiliate Transactions
- Accounting and Property Records
- Executive Compensation.

Liberty's audit has taken longer than anticipated to complete. The primary factors have included:

- Early delays in securing requested information, which slowed audit progress early, but which were largely resolved by Labor Day

- The intercession of significant liquidity problems, which created a need for the introduction of audit work associated with assuring that short-term cash flow requirements would not exhaust available company cash and credit
- Significant executive management and board of director changes after substantial field work had been conducted, which changes caused the need for significant additional field work
- The decision to sell NUI,[1] which created a need for assuring that utility operations and resources remain stable and sufficient during the period pending sale
- Substantial unforeseen efforts and difficulties in determining the timing and sources of intercompany balances and in assessing the plans for and likelihood of their payment, and the resulting impacts on utility financial structure and strength
- The pendency of fundamental cash-management systems changes to provide separation of utility and non-utility resources, which created the need to examine and test new systems, procedures, and controls, as they were being developed.

B. Company Description

The BPU approved NUI Corporation's petition to form a holding company in an order dated February 20, 2001. As a result of the formation of the holding company, the entity that was NUI Corporation became the entity providing utility services. The utility-services entity came to be called NUI Utilities, Inc. ("NUI Utilities"), and operated as a first-tier subsidiary of the newly formed holding company. This new parent took the name of NUI Corporation. NUI Utilities consisted of the resources dedicated directly to utility field and customer operations. NUI Utilities' business units (but not distinct subsidiaries) conducted the gas-distribution utility operations in New Jersey, Florida, New York, Pennsylvania, North Carolina, and Maryland. ETG has represented approximately two-thirds of NUI's gas distribution business by customer numbers, and about three-quarters by volumes of gas sold or transported. A second, first-tier NUI Corp. subsidiary, NUI Capital, included the entities that conducted non-utility activities; those entities included:

- NUI Energy, Inc.
- NUI Energy Brokers, Inc.
- Utility Business Services, Inc.
- NUI Environmental Group, Inc.
- NUI Energy Solutions, Inc.
- NUI Telecom (originally purchased as International Telephone Group)
- NUI International, Inc.
- Sales Management, Inc. (holder of NUI's interest in TIC Enterprises, LLC).

The holding company consisted of chief executive, financial, legal, and administrative support officers and other personnel who would in common serve the holding company, NUI Utilities, and NUI Capital. In general, these personnel consisted of people serving

[1] NUI announced the commencement of sale activities on September 25, 2003, and brought in outside help to prepare the company for sale, secure financing, establish budgets, prepare a cash forecasting tool, and reduce job positions and other expenditures.

in roles similar to those performed prior to holding company formation. Thus, two principal changes came with the creation of the holding company:

- To make the parent no longer the corporate entity from which NUI provided direct utility operations activities
- To remove non-utility operations from a direct ownership position by the corporate entity that provided these direct utility operations activities.

NUI has changed its utility operations since the holding company order. The following table summarizes the changes. Note that Virginia Gas is not operated by NUI Utilities.

Table I.1. NUI's Utility Ownership Changes

Operation	State	Acquired	Sold
ETG	New Jersey	pre 1998	
City Gas of Florida	Florida	pre 1998	
North Carolina Gas	North Carolina	pre 1998	Sep 2002
Elkton Gas	Maryland	pre 1998	
Valley Cities Gas	Pennsylvania	pre 1998	Nov 2002
Waverly Gas	New York	pre 1998	Nov 2002
Virginia Gas	Virginia	Mar 2001	

The following table briefly summarizes the chronology of non-utility operations.

Table I.2. NUI Non-Utility Ventures Creation

Subsidiary	Nature Of Operations	Year Begun
NUI Energy, Inc. ("NUI Energy")	Retail gas sales and related	Pre 1998
NUI Energy Brokers, Inc. ("NUI EB")	Wholesale energy brokerage and related services	Pre 1998
NUI Energy Solutions, Inc. ("NUI ES")	Energy project development and consulting	Pre 1998
NUI Environmental Group, Inc. ("Environmental")	Environmental project development	Pre 1998
Utility Business Services, Inc. ("UBS")	Customer account management; field operations systems	Pre 1998
TIC Enterprises, LLC ("TIC")	Sales and marketing outsourcing	Pre 1998
NUI Telecom, Inc. ("Telecom")	Full-service telecommunications company	Nov 1999
Virginia Gas Storage Co./Va. Gas Distribution Co. ("Virginia Gas")	Natural gas pipeline and storage operations	Mar 2001

II. Strategic Planning and Resource Allocation

A. Non-Utility Growth Plans

NUI made its first successful acquisition of a utility, City Gas of Florida (CGF) in 1988, as part of a gas-utility-centered growth strategy. By 1992 NUI had come to question whether continuing to grow through acquiring small LDCs would prove financially successful. NUI Corp. made its last acquisition of an LDC in 1994.[2] NUI sold the Valley Cities, Waverly, and North Carolina LDCs in the second half of 2002.

Growth plans for CGF have included construction of an East-West pipeline across the state of Florida. CGF took responsibility for the first phase of that installation, which cost $17 million; it has not produced the margins expected. The region has not witnessed the installation of the planned gas-fired electricity generating stations that formed much of the reason for expecting the first phase of the pipeline to be profitable. A number of new gas-fired electricity generating plants remain planned, but none are expected to come on line in CGF's territory before mid-2005. NUI Energy Brokers (NUI EB; discussed more fully in Chapter Seven of this report), NUI's energy trading subsidiary, now has responsibility for pipeline development beyond the first phase, which continues to be the responsibility of CGF. NUI has recently announced the next phase, which will include the development of storage at one end of the pipeline and an extension of the pipeline's operating length. NUI does not plan to use its own capital for this phase, but to rely upon capital from other sources.

Liberty wanted to review the plan that NUI laid out when it first decided to seek non-LDC growth opportunities. NUI responded that it no longer had a copy of the five-year plan that it adopted in 1995. Liberty found this to be outside its experience with other companies, who are generally able to locate such plans of comparable vintage. NUI did provide a group of presentation slides showing some basic parameters of its strategy as it existed a few years after 1995. Company objectives for 1997-2000 included three aggressive goals: 15 percent per year growth in earnings per share, 15 percent return on equity, and revenues of $1 billion per year.

NUI's plans focused on providing in the third-party marketplace the kinds of services that it considered similar to those it provided for itself in conducting utility operations. It likened the energy trading and sales and telecommunications resale activities it pursued to the management of its gas portfolio. NUI was especially enthusiastic about TIC, largely a commission-based seller of telecommunications equipment and US Postal Service expedited delivery services. TIC had short-term plans to grow employment quite aggressively. Its target of 600 personnel would exceed the number NUI was dedicating to providing utility service. The Company also promoted NUI Telecom, which resold to end users telecommunications services it was acquiring from primary carriers in the local, long-distance, and wireless markets, as another strong candidate for supporting NUI growth goals. NUI saw synergies between the marketing and sale of competitive

[2] There is a minor exception to this statement; Virginia Gas, acquired primarily because of its pipeline and storage assets, also serves several hundred end-use customers.

equipment and services that already existed in the telecommunications industry and similar developments that it was forecasting for the energy industry.

NUI's entry into its telecommunications businesses was late in the cycle, after telecommunications companies were starting to have problems. Other energy utilities also entered telecommunications businesses before NUI and were not realizing the success that they had hoped for. The difference between the other utilities and NUI was the relative size of their commitments—NUI made a big investment when compared to the size of the rest of the company.

TIC pursued its expansion goals. Its costs grew rapidly; however, its sales, generated in a slumping economy, did not. NUI believed that TIC's problems were not systemic, but could be improved by a change in operational control. NUI therefore moved from a minority, 49 percent, ownership position to 100 percent ownership, by buying out the majority owner and operator of the business. NUI did succeed in reducing the size of TIC's monthly operating losses (although it could not eliminate them), but gave up quickly on the goal of turning it around, shutting down its base operations within months of having purchased the controlling interest. It shut down most of TIC's operations after failing to find a buyer for them; the rest moved to NUI Telecom.

NUI did not fare much better in the retail energy market. The Company sold its competitive retail energy supplier, NUI Energy, in early 2003, after generating operating losses of $3 million (after taxes) in the first half of fiscal 2003. NUI's combined experiences with TIC and NUI Energy proved very disappointing financially. NUI Telecom fared somewhat better, but this venture also failed ultimately to contribute substantially to the earnings growth that NUI was seeking and projecting, and produced sizeable losses on the disposition of its assets. NUI Telecom is now under an agreement of sale that will generate far less than the costs of acquiring the several businesses that have comprised it.

At generally the same time, NUI pursued a number of international and environmental ventures. None has succeeded even in producing consequential revenues, let alone contributions to earnings. NUI felt that the personal contacts of its board chairman and the Company's knowledge of the restructured natural gas industry in this country positioned it well to employ other parties' capital to capture opportunities as markets in Eastern Europe started to open. This proved not to be correct. These ventures experienced significant and repeated financial losses across the years of their operation. Harbor dredging comprised the environmental venture to which NUI committed substantial financial resources. NUI tried to create a technology that would solve a long-standing impediment to continued operation of the New York harbor area, and then find other partners to advance the capital necessary to implement the solution.

NUI found that, as in the case of its international ventures, others expected NUI to contribute not just its contacts, concepts, and technology solutions, but also money. After spending considerable sums trying to put together salable international and environmental business ventures, NUI produced almost no sales or revenues at all from them, found no partners, and eventually found no buyers.

NUI's goal was a lofty one; it tried to transform itself from a small company focused on running a small to moderate group of LDC businesses into one with greatly increased operational breadth and financial size. NUI brought in many new executives, most of whom are now gone, and it dedicated the equivalent of nine person-years (18,000 hours) of employee time in the 2000 time frame to produce a fundamental change in its culture. NUI began to define itself as the diversified energy company it wanted to be, rather than the largely LDC company that it remained in terms of financial contribution. Even its executive compensation program used diversified energy companies and companies larger than itself as a comparison base.

In the spring of 2001, NUI continued to expect and to target a very aggressive rate of growth. The annual spring planning retreat, including directors, corporate executive management, and business-unit leaders, talked about:

- Doubling the economic value of NUI in five years (it would take a compound growth rate of 15 percent to accomplish this growth)
- Executing each year transactions that would have at least a cumulative effect of 20 percent on financial performance
- Providing returns to stockholders that would exceed the rate of return of the S&P 500 companies
- Expanding NUI Environmental's dredged-material management by one additional harbor per year, and developing three new product applications for waste materials (when this subsidiary as yet had no commercial operations of any kind)
- Expanding UBS revenues from $10 million to $135 million, its earnings before interest and taxes from $1 million to at least $25 million, and the share of its revenues and earnings earned by acquired businesses from 0 percent to least 60 percent.

In September of 2001, NUI's executive compensation consultant highlighted the aggressive nature of these and other goals that formed part of the strategic plans. The consultant reported that only 10 percent of S&P 500 companies beat the median total shareholder return every year for three years, and that only five percent were able to so for five years. In addition, NUI's goal of earning two percent above its cost of capital meant that it would have to earn returns of 8 to 10 percent, while the consultant's data showed that only a quarter of S&P 500 companies were able to earn a return on invested capital of 10 percent for five years.

B. Utility Budgets and Resource Availability

Liberty's audit scope did not include performing the management and operations reviews necessary to determine the efficiency and effectiveness with which ETG has delivered service. However, examination of a number of trends gave no reason to suggest that ETG's baseline level of service delivery cost or effectiveness has changed materially as NUI found itself in increasing financial difficulty. Liberty's review of capital and operating expenses showed no indication of reductions, either in budgets or in actual expenditures. Service performance metrics, while limited, have not showed any sign of deterioration. Moreover, the rates of change in key areas of expenditure at ETG over the past several years are consistent with the experience of New Jersey's two other gas-only LDCs.

Liberty did not find that NUI's financial problems had a negative effect on ETG's operations and capital investments. As the pressures from the financial problems increased in 2003, however, there were threats that NUI's executive management might reduce the resources available to ETG so much that it would have to have degraded ETG's service. Even though the reductions were not instituted, that they were even studied, and that other related activities were started, raises important issues about NUI's stewardship of its largest utility business. Beyond that question is a broader one of NUI's lack of candor in dealing with other interested parties regarding its financial commitments to the utility business. These topics are addressed below.

ETG's capital needs have generally run at about $28 million per year. NUI budgeted sufficient funds to meet ongoing ETG needs until fiscal 2003. In September 2002, facing dwindling liquidity and pressure from the financial community, NUI cut $11 million from NUI Utilities' capital budget on a publicly-expressed basis. This action was not consistent with the capital budget that the ETG advisory board had just approved. No effort was made to seek that board's input as part of this cut.

NUI Corp. and NUI Utilities executives understood that there would be no real cuts at all, because utility capital spending, by specific agreement made at the time of budget approval, was expected to and did continue at the rate proposed before the September cut. Despite continued spending at a higher level, NUI reports to the financial community through the spring of 2003 continued to show capital budgets lower than those of the preceding year. The dollars were formally restored to the budget later, through actions ending with the NUI Corp. board's July 2003 restoration of $8 million to the NUI Utilities capital budget.

A similar course of events transpired at the time normally slotted for approval of the 2004 NUI budgets. The NUI CFO/COO determined at the end of August 2003 to commission a major study of costs that employed the support of an outside consultant. The NUI CAO/General Counsel managed the effort. The steering committee established to guide these efforts consisted of NUI Corp.'s three most senior officers: the CEO, CFO/COO, and CAO/General Counsel. The expressed driver of the effort, which coincided with the start of NUI's fiscal year 2004, was to identify ways to meet investment analyst targets for NUI income for the looming fiscal year. The overwhelming focus of the effort was on staffing reductions. The study identified ways to secure the $26 million in cost reductions that would be necessary to meet earnings targets.

The identified cuts were extreme, and making them quickly was necessary to support earnings per share targets. The analyses identified personnel reductions of between 22 and 59 percent, which would have produced operating expense cuts of $27.7 to $52.3 million. Specific goals included three reductions directly related to ETG and three that affected other portions of NUI. The following table summarizes the identified reductions.

Table II.3. Summary of Proposed Reductions

Area/Timing	Area	Reductions
ETG-Related		171
November 2003	Corporate Shared Services	60
May 2004	Utilities North(1)	58
October 2004	Corporate Shared Services	53
Other		41(2)
By September 2003	Discontinued Operations	(2)
February 2004	Other Businesses	11
July 2004	Utilities South	30

(1) ETG, Elkton, and New Jersey Appliance Business
(2) Estimated or unclear from the available information

The CAO/General Counsel told Liberty that there never was a forced NUI goal to meet earnings expectations, but that the earnings-per-share standard and the staff reductions were only put forth as a "hypothetical." He said that he ended the work on September 24, 2003, when it became clear that a major management change was set to take place. Liberty considers the explanation of the cuts as hypothetical to be implausible. Nevertheless, it is not certain that NUI actually intended to make the drastic cuts. Another explanation fits the facts, and finds precedent in the treatment of the fiscal 2003 capital budget for NUI Utilities. This explanation is that NUI anticipated the creation of investor expectations that the Company would take strong measures to meet earnings estimates for fiscal 2004.

There are as yet no approved ETG expense budgets for fiscal 2004. Therefore, for at least the past two years, utility management has been forced to operate under an unusual amount of uncertainty because of the poor performance of NUI's non-utility investments.

C. Summary of Planning and Resource Allocation Conclusions

1. NUI's strategic planning for non-utility growth became unreasonably aggressive in the late 1990s, by incorporating a goal of growing at a rate far faster than general industry growth and by failing to be sustained by clear, concrete means for reaching that goal.

2. NUI planning for its non-utility businesses was unrealistically optimistic and did not adequately consider the financial risks the company was taking and the implications of those risks for ETG.

3. NUI's aggressive assumptions about a number of its growth engines did not have analytical foundations, and, in at least one case, ran contradictory to the clear advice being received from its own consultant.

4. NUI's growth depended greatly on success in the telecommunications sector into which NUI entered late in its cycle and with investments that were too large compared to the rest of NUI..

5. NUI has exercised insufficient control over capital budgeting and reporting for its non-utility investments.

6. NUI Corp. announced or prepared to announce arbitrary and unsupported actions with respect to ETG capital and operating expenses and personnel, as part of an investor-community driven approach to managing the corporation.

7. NUI's management apprised the board of directors of the plans it had for the non-regulated subsidiaries, but did not keep the board promptly and sufficiently informed about the Company's financial problems as they were developing.

8. Despite the major and continuing financial problems of its non-utility ventures, NUI did not make any curtailments in utility spending or resources, and experienced no noticeable degradation in service quality.

III. Affiliate Relations

A. General Affiliate Issues[3]

NUI Corp. provides corporate administrative functions such as accounting, human resources, legal, and information technology (IT) to NUI subsidiaries. The auditor that conducted the most recent competitive services audit of ETG concluded that there existed a number of shortcomings in NUI's cost-allocation procedures. The two most significant problems were:

- Use of a size-based three-factor formula to allocate the costs of shared corporate functions
- Lack of full allocation of costs from business units to departments.

The auditor before that one raised similar concerns. Liberty also reviewed the process by which NUI Corp. allocates costs. NUI uses a three-factor formula to assign most of the costs incurred to provide shared overhead and support services. This factor consists of the equally weighted average of relative subsidiary labor, plant, and customers. The prior two competitive services auditors found it to be an unreliable and inappropriate method for assigning the costs of the services that a subsidiary actually consumed. Liberty's detailed examinations of NUI Corp. subsidiaries and the challenges and needs that they have imposed strongly support concerns about its use at NUI. The three-factor allocator has been in use at NUI for an extended period of time. There is no single answer as to which general allocator formula is most appropriate. Liberty's concern is not per se how NUI structured the allocator, but that it far overused it. Such allocators provide at best an indirect indicator of cost causation. NUI was engaged in aggressive non-utility

[3] Energy affiliates are treated in Section Seven of this interim report.

expansion efforts, and created a large, expensive administrative and support team to support them.

The substantial growth in headquarters staff and costs did not materially improve NUI Utilities' operations. Nevertheless, those operations paid for the strong majority of added support costs, because of overuse of the three-part allocator. NUI should have undertaken efforts to charge significantly more administrative and support costs to its non-utility operations. Doing so would have been consistent with the existence and long use of the allocator. There has been no requirement for NUI to use the allocator almost exclusively. To the contrary, good utility practice, even where such allocators exist, is to favor more direct means of charging or allocating when use of a general allocator is not a sufficient indicator of cost causation.

ETG's most recent competitive services auditor also found that NUI had not been fully allocating all the costs attributable to business units to the departments in those business units. NUI typically used costs at the department level as the basis for allocating most common costs. In many cases the true cost of the shared services were not properly charged to the benefiting business unit. Liberty agrees that NUI's method for allocating corporate services does not reflect fully-loaded costs, and may result in cross-subsidization.

The most recent competitive service auditor also identified problems in how NUI allocated the cost of buildings that it owns and leases. One of the more significant problems identified was NUI's lease of the building in Union from a real estate group whose ownership includes the Chairman of the NUI Board of Directors.[4] In 2000, NUI extended by 15 years the term of the lease for the Union, NJ building where ETG's principal offices are located. The change reduced the rental rate and gave the lessee control over operating expenses, but required the lessee to increase its leased space to 100 percent of the building. This change increased the amount rented from 160,000 to 200,000 square feet. Annual costs to NUI in total fell by about $660,000 per year, and the reduction could reach $1.1 million if lessee(s) can be found for now-vacant space.

NUI changed in 2003 to a market-based rate for affiliate space occupation (including NUI Utilities) in the Union building. The building also contained vacant space and space occupied by third-party lessees. NUI allocated to affiliates (again including NUI Utilities) the total costs for portions of the building not occupied by affiliates, net of the rentals received from third parties. The net result is that affiliates, including NUI Utilities, pay a market rate for the space they do occupy and, on top of that, a share of NUI's unrecovered costs for the remaining building space, which they do not occupy. The costs to ETG of charges beyond those attributable to the space it occupies are in the range of $900,000 per year, as Liberty calculated them. The recent competitive services auditor reached a somewhat higher amount of excess costs; both its method and Liberty's provide fair approximations of excess annual costs historically incurred. In reaching this conclusion, Liberty is mindful of the fact that unused space at Union is directly related to

[4] The NUI Chairman did not participate in lease negotiations.

the occupancy of space at Bedminster by shared-services personnel transferred from Union. NUI Utilities also pays a share of the costs of that space.

B. Summary of General Affiliate Conclusions

1. NUI has failed to capture adequately and allocate fully the costs that its non-utility operations have imposed, which has resulted in the allocation of excess costs to ETG.

2. As its competitive services auditor found, Liberty concluded that NUI paid insufficient attention to developing proper overhead rates for its charges among affiliates.

3. ETG has borne and will in the future bear even greater responsibility for substantial rental costs, as more space in Bedminster and Union is rendered excess by non-utility operations reductions, that should be allocated to non-utility operations.

C. Utility Business Services (1987)

Utility Business Services, Inc. (UBS) provides print and mail services (billing), payment processing, use of a propriety customer information system (WINS CIS), and data center services for water and waste water utilities. UBS arose from an entity called Computil, which NUI began in 1969. NUI sold Computil in 1987, but retained the billing-services business line that UBS still operates today.

UBS has also performed billing and payment processing for NUI Utilities' ETG, CGF, and Elkton operations.[5] Operations Applications and Services (OAS), a unit that has been part of UBS, performs geographical mapping and tracking of utility distribution property. In July, 2003, NUI announced that it would begin to market UBS for sale. NUI planned, however, to retain the OAS business unit. UBS used the NUI mainframe computer and billing/inserting equipment from 1998 to 2000 for its operations, under an agreement with NUI Corp. NUI is now evaluating firm offers from potential buyers.

The following chart shows the rates of change in charges from UBS to NUI Utilities across the past two fiscal years, and as proposed under the agreement pursuant to which UBS proposes to charge NUI Utilities after its sale to a third party.

Table III.1. Increases in UBS Charges to NUI Utilities

Service	2002	2003	2004	2005	2006
Print Mail (PM)	Base	6.67%	12.50%	5.56%	5.26%
Payment Processing (PP)	Base	47.37%	0.00%	3.57%	3.45%
Data Center (DC)	Base	20.00%	2.78%	2.70%	2.63%
PM + DC	Base	15.56%	5.77%	3.64%	3.51%
PM + PP	Base	29.41%	4.55%	4.35%	4.17%
PM+PP+DC	Base	25.00%	3.75%	3.61%	3.49%

The table shows a very substantial increase in fiscal 2003 charges. It is reasonable to limit UBS charges to 3 percent annual increases from 2002 levels through the end of its services to NUI Utilities. To the extent that the increases are not so limited, it should be clear that costs in excess of this amount cannot be recovered through ETG rates for service to New Jersey customers.

The new agreement under which UBS will serve NUI Utilities is intended to provide for services until a sale of NUI is completed, at which time the parties contemplate that the new owner will otherwise provide for the services itself. The agreement is, however, grossly out of line with that assumption because it provides for a term ending on March 31, 2007, which adds service for a number of years beyond any reasonable termination date.[i] In addition, the agreement requires NUI Utilities to pay, should it elect to terminate the agreement, roughly half of the remaining amounts that would be due through March 31, 2007. In contrast to these provisions, all NUI Utilities needs from UBS is continuation of the agreement for a term sufficient to allow it to price and secure other services, whether through those provided by a new owner after a sale or through solicitation of outside services.

The parties have been willing to work in the past without a fixed term or termination payments. Moreover, UBS needs to make no new investments or staffing changes to continue serving NUI Utilities. It is appropriate under the circumstances to provide for a term no longer than necessary for NUI Utilities to examine and provide for other outsourced opportunities. It is, therefore, unreasonable to provide UBS with a virtually certain payment, the effect of which is to inflate the price that NUI will receive on the sale of UBS, while saddling ETG with an unnecessarily costly legacy. While those costs will not find their way into rates absent BPU approval, it is important to establish that there is no potential for recovery of any such legacy costs from ETG customers.

NUI Utilities has stated that it does not intend to examine its alternatives to UBS.[ii] Absent pricing provisions such as those recommended herein, such efforts should commence immediately.

There is no performance-standard clause that obligates UBS to provide services of the same nature and quality it has provided historically. There is a declaration of intent (in the scope-of-services section of the agreement) that quality be the same as existed previously, but this provision is not sufficiently comforting given that UBS will be owned by a third party. NUI Utilities will be seen as a short-term customer of the new owner; stronger performance standards are necessary to assure that there is no degradation in quality.

ETG's customer information system, called CSS, is separate from the system UBS has used for its water utility customers. In 1998, when NUI began to investigate a new utility CSS, it paid UBS to examine modifying the UBS water utility system, WINS CIS, to replace the existing ETG CSS. The conversion work was not covered by a written contract between the utility and UBS. When work started, NUI transferred NUI Utilities' billing activities to UBS as well, in anticipation of its development, implementation, and operation of a new gas utility CSS. UBS therefore took over utility billing in 1998. When UBS took over the utility billing, a group of employees from corporate IT transferred to UBS, continuing, as they had when they were part of corporate IT, to have responsibility for application support of the ETG, CGF, and Elkton CSS. NUI decided around July 2001 that the Wins CIS conversion effort would not meet NUI Utilities needs. UBS then transferred the CSS support employees back to NUI Corporate IT.

UBS had been using corporate IT equipment for a long time before it took over the NUI Utilities CSS support function in 1998. It had paid for the use of that equipment and the costs of the NUI Corp. IT personnel who operated it through a facilities management fee. It stopped paying that fee at around the time it took over the NUI Utilities billing functions, even though UBS continued to use corporate equipment that it had been paying for before then. Liberty could find no evidence of a recorded asset transfer from NUI Corp. to UBS, which has said alternatively that there was a transfer, there was no transfer, and that the equipment transferred was fully depreciated and without economic value. The corporate processing and receipt equipment was retired. It was replaced by new equipment that UBS acquired at its expense through a number of purchases made in 2000. NUI neither made nor has a calculation of market value of the equipment transferred; however, it is not reasonable to conclude that it approaches the cost of the replacement equipment, given age and obsolescence considerations.

The UBS server now hosts the NUI Utilities CSS and UBS prints and mails NUI Utilities customer bills with equipment that UBS acquired. NUI Corp. equipment cannot perform these functions, which limits the options of NUI Utilities upon the sale of UBS. Liberty reviewed the agreement that will continue UBS services to NUI Utilities pending a consideration of utility options. The agreement is generally satisfactory, but contains a number of pricing and other provisions about which Liberty has concerns that remain open pending review of information just supplied by the company.

The portion of the NUI Utilities engineering group responsible for geographic-information system activities was transferred to UBS to form OAS in July 1998. This group continued to develop system capabilities begun as part of utility operations, and it began to sell those capabilities to third parties. The group also continued to perform work for NUI Utilities, but on a different basis. No longer did the utility bear actual costs, but OAS began to work on the basis of estimated job costs that included a markup to allow OAS an opportunity for profit.

UBS still makes substantial sales to NUI Utilities, but growth in its outside business has reduced the in-house share of revenues to about 35 percent. All OAS revenues came from NUI Utilities when it began operations in 1998, but the percentage is now about half that amount.

On a combined basis, UBS and OAS have contributed an average of about $800,000 per year in pre-tax profits to NUI for the past five years. Since 1998, their combined share of the intercompany payable balance has grown from $800,000 to $3.9 million. The subsidiary's balance sheets show this amount as notes payable to banks, which they are not, rather than to affiliated companies, which they are. NUI's planned sale of UBS excludes OAS, which will be returning to NUI Utilities. The firm offers received for UBS, which NUI is now considering place a value of less than half of the NUI's earlier estimates of what the sale of UBS would produce.

D. Summary of Utility Business Services Conclusions

1. UBS and OAS have produced consistent, moderate operating profit, but their operations have also been funded through the corporate cash concentration account, and ultimately NUI Utilities, for a cumulative total of about $3.9 million.

2. UBS received from an affiliate the transfer of at least the beneficial use of equipment for which it had previously made annual payments, without documenting any formal asset transfer and without continuing to pay appropriate fees therefor.

3. UBS has provided services to NUI Utilities with no written agreement, making it impossible to independently establish responsibilities, pricing, duration, or other material terms and conditions.

4. The services of UBS for NUI Utilities were provided without the benefit of any analysis of marketplace alternatives.

5. NUI inappropriately permitted NUI Utilities to fund the development of a customer information system intended for sale in the open market.

6. OAS was permitted to appropriate without compensation utility-created intellectual property that it used as a basis for services sold to third-parties.

7. NUI Utilities engineering-services resources that were providing geographic-mapping services at cost for utility operations were transferred to OAS non-utility operations, after which pricing inappropriately changed to cost plus a mark-up, in order to provide a profit margin for NUI's non-utility businesses.

8. NUI has not protected utility interests adequately in selling UBS; the agreement of sale would provide NUI with excess profit at the expense of ETG and it fails to provide sufficient assurances that ETG will continue to receive the quality of service it has gotten in the past from UBS.

E. NUI Environmental Group, Inc. (1996)

NUI Environmental Group, Inc. (NUI Environmental) is a subsidiary of NUI Capital. NUI Capital formed NUI Environmental in fiscal 1996 to develop a solution to the rapidly decreasing accessibility of the New York/New Jersey Harbor to international commercial shipping traffic. NUI Environmental's sole project involved the decontamination of sediment dredged from the NJ/NY harbor area. NUI Environmental completed work in fiscal 2001 on a $485,000 pilot study project to demonstrate the effectiveness of an innovative process for the treatment of dredged material.[6]

In September 2002, NUI began seeking a buyer for NUI Environmental. The Company stated it believes that it has demonstrated the effectiveness of the technology, but preferred not to commit the capital resources necessary to fully deploy it in the form of building a decontamination facility. This was also a time of serious funding access problems. As of September 30, 2002, NUI began to report NUI Environmental financial results as discontinued operations, and stopped operations as of June 30, 2003.

NUI Environmental had only two employees until 2003, when its complement dropped to one -- the executive in charge of the project. NUI Environmental has not had transactions with NUI affiliates except for allocations from NUI Corp. (between 5 and 10 percent of this affiliate's total operating expenses) for overheads and general support functions.

The Company has stated in filings with the SEC that NUI Environmental has not generated any operating revenues. Its income statements show negative net income in each year of its existence, running from about one half million to one and one half million dollars since 2000. NUI Environmental has an intercompany payables balance that grew from zero in September 1997 to about $6.5 million at June 30, 2003. The subsidiary's balance sheets show this amount as notes payable to banks, which they are not, rather than to affiliated companies, which they are.

F. Summary of NUI Environmental Conclusions

1. NUI Environmental has produced steady losses since its creation. Its operations have been funded through the corporate cash concentration account, and ultimately NUI Utilities, for a cumulative total of $6.5 million.

2. NUI Environmental did not have material transactions with affiliates, other than by the general allocators used to account for support services from NUI Corporate.

G. TIC Enterprises (1997)

TIC Enterprises, LLC (TIC), an NUI Capital subsidiary, provided commissioned sales and marketing for various businesses, primarily involving telecommunications equipment. NUI Capital purchased 49 percent of TIC through its subsidiary Sales Management in 1997. This subsidiary acquired the remainder of TIC in May of 2001. NUI Capital exercised rights to acquire the remaining ownership share of TIC in the face of significant operating losses, believing that acquiring operating control of the business would allow it to reverse sizeable losses. In total, NUI Capital paid $34.1 million more for TIC than the fair value of its assets (carried on TIC's books as a goodwill asset).

TIC's sales teams sold equipment, local and long-distance service, cellular phone service, and network services in the telecommunications industry. TIC also provided an

[6] NUI Environmental received a draft contract (never entered) from the State of New Jersey for the Demonstration phase in December 2002.

outsourced sales force for United States Postal Service expedited delivery services. TIC incurred very substantial expenses to grow a large sales force, but experienced significant drops in its telecommunications and postal service business by 2002.

TIC sold just over $1 million worth of telecommunications equipment and services to NUI Corp., which used them to provide common services to NUI affiliates, including ETG.[7] NUI Corp. did not charge TIC any share of common overheads or services for 2001, and did not file with the BPU the equipment sale and service agreements.

During two full years of operation under NUI control, TIC lost $12 million (2001) and $31 million (2002, which included an operating loss of $13.6 million and a loss of $17.6 million due to an accounting change). NUI has shut down TIC operations (excepting limited business lines transferred to NUI Telecom) after failing to find a buyer, making all of its investment and the substantial operating losses on top thereof unrecoverable. Some of the funding to cover TIC investment and operating losses has come from NUI's common cash pooling arrangement and from the intercompany receivable, under which NUI Utilities is owed very substantial sums of money from NUI Capital and other non-utility NUI Corp. operations. TIC's share of the intercompany balance peaked at $21.2 million at June 30, 2003, and fell to $14.0 million by September 30, 2003. The subsidiary's balance sheets showed the balances as notes payable to banks, which they are not, rather than to affiliated companies, which they are.

H. Summary of TIC Conclusions

1. TIC has produced crippling operating and write-down losses since its creation.

2. TIC's operations have been partially funded through the corporate cash concentration account and ultimately NUI Utilities for about $21.2 million (peak) at June 30, 2003, falling to $14.0 million by September 30, 2003.

3. NUI failed to require TIC to operate its business with affiliates: (a) in compliance with the holding company order requirement involving reporting of administrative service agreements, and (b) in a manner that permits verification of the reasonableness and prudence of the need for and costs of goods and services provided.

I. NUI Ventures (1998)

NUI formed Ventures as a department of NUI Corp., not as a separate subsidiary of NUI Capital, in 1996 to centralize development of projects and new business opportunities, and take peripheral businesses out of ETG and NUI Utilities. NUI International, Inc. (International) is a wholly-owned subsidiary of NUI Capital, organized to explore international business opportunities. NUI shut down NUI International and Ventures in September 2003, transferring one potential opportunity (gas trading) to NUI Energy Brokers. NUI Ventures held oversight responsibility for NUI International and two other subsidiaries of NUI Capital, *i.e.*, NUI Environmental and UBS, and for a fuel-cell project.

[7] NUI has said that TIC acted only as a commissioned seller for Nortel, but NUI accounting records show TIC as the billing party to NUI.

NUI Corporation started taking an interest in international opportunities in 1998, focusing on Russia and several other Eastern European countries. The plan was to take advantage of experience and contacts as gas markets opened there. The projects examined eventually included gas exports, a trans-Siberian fiber optic backbone, compressed natural gas as an automobile fuel, and gas trading. NUI did not seek to invest its own capital at material levels, but to parlay its experience and contacts into equity interests in ventures that would be funded by partners.

None of the NUI Ventures projects, including those of NUI International, produced revenues. NUI Ventures, however, lost money in each of its six years of operation (somewhat over $1 million per year on average), and generated an $8.5 million intercompany receivable, which NUI Ventures balance sheets show as a note payable to banks, which it is not, rather than to affiliated companies, which it is.

J. Summary of NUI Ventures Conclusions

1. NUI Ventures and NUI International have produced steady losses since their creation. NUI Ventures' operations as a department of NUI Corp. and NUI International's operations as a subsidiary of NUI Capital have been funded through the corporate cash concentration account, and ultimately NUI Utilities, for a cumulative amount of about $8.5 million at June 30, 2003.

2. NUI Environmental did not have material transactions with affiliates, other than those addressed by the general allocators used to account for NUI Corp. support services.

K. NUI Telecom (1999)

NUI Telecom, Inc. (Telecom), a wholly-owned subsidiary of NUI Capital, provides telecommunication services to small and medium-sized businesses, primarily through the resale of services that it acquires from primary local-exchange, long-distance, and wireless carriers. NUI acquired a company known as ITG in November, 1999 and subsequently changed the name to NUI Telecom, Inc. The purchase price totaled $3.8 million; NUI also paid the sellers an additional $1.0 million because the enterprise met certain earnings targets. NUI later acquired Norcom, Inc., a provider of telecommunication services in the Northeast and Southeast, for $4.2 million. In May, 2002, NUI agreed to acquire certain assets of Telcorp, Ltd., a reseller of advanced voice and data services, for $3.4 million. NUI Telecom paid Telcorp a post-closing adjustment of $3.8 million in April 2003, in order to complete the acquisition of Telcorp.

In June, 2003, NUI approved a plan to sell Telecom, after which it began to report financial results as discontinued operations. The Company recorded a write-down of $11.6 million in goodwill from the acquisitions of other companies and $4.8 million for intangible assets relating to customer relationships.

NUI Telecom took over responsibility for supplying a number of NUI Corp.'s telecommunications services. It also consolidated NUI's telecommunications bills, providing one bill for its services and for those that continued to be provided by others.

NUI Corp. stopped this practice because it did not see value in NUI Telecom's review of outside providers' bills. NUI Corp. allowed NUI Telecom to determine what portions of NUI Corp.'s business to take over from third parties without analyzing whether NUI Telecom was the most effective alternative to then-current third-party suppliers. NUI Corp. also has never had an agreement with NUI Telecom, which exposed NUI Utilities to risk as the Company completed negotiations to sell NUI Telecom.

NUI Telecom operated as a subsidiary of NUI Capital for most of fiscal 2000, but NUI Corp. did not begin to allocate overhead and support costs to it until fiscal 2001.[8] NUI's policy was not to change a fiscal year's corporate allocations after their initial establishment. Through organic customer growth and its acquisitions of other small telecommunications providers, NUI Telecom was able to increase its operating revenues from $5.2 million in 2000 to $35.6 million in 2003. Its operating margins grew from less than $1 million to $11.5 million in this period; however, very large increases in operating expenses meant that NUI Telecom has suffered a loss before income taxes in each of these years, averaging somewhat over $2 million. Like NUI Corp.'s other non-utility operations, it has seen a substantial growth in its intercompany balance, which ran at about $2.8 million in its first year of NUI ownership, and grew to $22.1 million by June 30, 2003. The subsidiary's balance sheets show these amounts as notes payable to banks, which they are not, rather than to affiliated companies, which they are.

There exists a definitive agreement to sell NUI Telecom to management, led by the executive who was with ITG when NUI bought it originally. NUI had estimated a sale price for planning purposes; however, the price it will obtain is in the range of half that amount. The execution of the sale agreement will return to management in essence all of ITG and the subsequent telecommunications purchases (excepting TIC) that NUI has made, but at a very steep discount from what NUI paid to assemble the business..

L. Summary of NUI Telecom Conclusions

1. NUI failed to require NUI Telecom to operate its business with affiliates: (a) in compliance with the holding company order requirement involving reporting of administrative service agreements, and (b) in a manner that permits verification of the reasonableness and prudence of the need for and costs of goods and services provided.

2. NUI Telecom has produced losses since its creation. Its operations have been partially funded by the corporate cash concentration account, and ultimately NUI Utilities, for a cumulative total of about $22.1 million at June 30, 2003.

3. NUI failed to make adequate allocations of corporate costs for NUI Telecom.

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[8] None of fiscal 2000 fell into the test year (June 2001 through May 2002) for ETG's last base rate case before the NJBPU.

IV. Finance

A. Financial Results and Credit Ratings

1. Financial Results

ETG has provided the bulk of NUI Corp. net income and dividends. The following table shows NUI Utilities net income from fiscal 1998 through June 30, 2003.

Table IV.1. NUI Utilities Net Income: 1998-2003

Entity	1998	1999	2000	2001	2002	2003
ETG	12,812	19,201	21,138	19,907	15,098	19,171
CGF	1.187	1,662	(3,673)	746	1,783	(1,314)
Elkton	229	527	398	567	71	220
North Carolina	342	415	889	608	(373)	(346)
Valley Cities	(80)	316	95	(101)	1,410	(128)
Waverly	(67)	(52)	(34)	(40)	(424)	22
NUI South	(235)					
Appliance Business			3,580	(675)	(333)	(450)
NUI Utilities						(193)
Utilities Total	14,188	22,069	22,393	21,012	17,232	16,982

Note: Amounts are in thousands of dollars; fiscal 2003 entries are unaudited.

During this same time period, NUI Corp. invested heavily in its non-utility businesses. NUI Corp. did not meet with the same financial success in its non-utility ventures. The following table shows net income by non-utility venture.

Table IV.2. NUI Corp. Non-Utilities Net Income: 1998-2003

ENTITY	1998	1999	2000	2001	2002	2003
NUI Energy	(1,524)	853	(669)	1,315	(1,551)	(9,982)
NUI Energy Brokers	(125)	2,347	4,419	7,562	6,864	2,376
NUI Telecom			(574)	(936)	(2,218)	(26,082)
TIC				(5,425)	(31,281)	(4,302)
Energy Solutions	(60)	(51)	(237)	(24)	(63)	(31)
NUI Capital	864	902	1,111	(5,188)		
UBS	554	471	587	917	191	528
NUI Ventures	(238)	(720)	(1,303)	(1,210)	(2,506)	(1,172)
NUI Environmental	(92)	(163)	(1,677)	(797)	(1,275)	(860)
Virginia Gas				108	(401)	(649)
Saltville Storage						109
Net Non-Utility Income	(621)	3,639	1,657	(3,678)	(32,240)	(40,065)

Notes: Amounts are in thousands of dollars; fiscal 2003 amounts are unaudited.

NUI experienced very significant losses and write-offs in the non-utility businesses during recent years. These non-LDC losses from 2000 through June 30, 2003 resulted from operating losses and from changes in accounting standards FAS-144 and FAS-142.

NUI's net cumulative equity investment in non-utility businesses reached about $165 million through June 30, 2003. NUI wrote off or experienced losses ($94.5 million) of more than half of this investment from fiscal 2000 through June 30, 2003.

2. Capital Structure

ETG's equity as a percentage of permanent capital structure ranged from 43.3 to 47.0 percent at fiscal year-end for the years 1998 through 2001. NUI Corp. issued common stock in March 2002; this issuance secured $37.2 million in net proceeds. NUI Corp. allocated 100 percent of the proceeds of this equity sale to ETG; it allocated no equity to NUI Corp.'s non-regulated businesses or other utility divisions. NUI very shortly thereafter filed an ETG rate case that included the increased equity. The rate filing presented an equity level of 52.5 percent of permanent capital.

NUI did not retain this level of "book equity" in ETG, however. NUI recorded a "special dividend" of $31.9 million to NUI Corp in June 2003. NUI management's explanation to Liberty was that ETG should have paid higher dividends to NUI Corp. from 1996 through 2002, because dividends actually paid represented only 48 percent of net income. The declaration of this additional $31.9 million dividend for periods well in the past would bring dividends to 75 percent of net income for this period. In summary, NUI Corp. first added to ETG's equity through the NUI stock issuance before the 2002 rate case; second, pursued a rate increase on that base; then third removed an amount approaching that addition after the case before the NJBPU.

Another fact of concern regarding ETG's equity levels is that the inter-company balance owed by NUI Corp. to NUI Utilities has not been below $54.7 million since allocation of the March 2002 NUI Corp. equity issuance to ETG. Amounts owed by NUI Corp. to NUI Utilities represent cash and equity that financial management left on the accounting records of NUI Utilities, but that were not available to utility operations. These funds were tapped, through the common cash concentration account, by affiliates whose need for the NUI equity raised were actually much greater; i.e., NUI's non-utility businesses. An accounts receivable from NUI Corp. represented these "missing funds" on the books of NUI Utilities and ETG. The net result is that NUI's rate filing matched ETG's equity percentages neither before nor shortly after the rate case. More significantly, this chain of events demonstrates that ETG never effectively had the use of the equity capital represented by this NUI Corp. stock sale.

A key conclusion of a recent 2001 and 2002 PricewaterhouseCoopers' audit of NUI Utilities was that a downward adjustment be made to NUI Utilities' fiscal 2002 year-end equity capital in the amount of $61.4 million. This reduction in equity capital reflects that the inter-company payable from NUI Corp. to NUI Utilities at year-end 2002 could not be treated as an NUI Utilities asset, given the lack of evident planning and capability to make repayment. NUI Corp. reported the inter-company balance owed to NUI Utilities to be about $85 million at fiscal-year-end 2003.[9]

[9] The next chapter of this report addresses accounting and controls; it discusses Liberty's ongoing efforts to validate this balance.

If the same principles were to be applied to this balance as of the end of the 2003 fiscal year, NUI Utilities' equity would thereby decrease by about an additional $24 million. Such a reduction would leave NUI Utilities and ETG with permanent capital structures containing only about 38 percent equity capital. Such levels of equity capital are too low to attain investment grade credit ratings on a forward-looking basis. These levels of ETG equity capital also fall far short of the 52.5 percent level of permanent equity capital included in the Company's 2002 rate case filing.

A major refinancing through Credit Suisse First Boston (CSFB) closed just as this report was prepared. It produced sufficient cash for NUI Corp. to repay the receivable (subject to validation of the correctness of its calculated amount) to NUI Utilities, thus mooting the need for a further NUI Utilities equity write-down for fiscal 2003. Following sections of this report discuss that financing in greater detail.

3. Credit Ratings

The decline in NUI Utilities' credit rating since September 2002 came from the financial difficulties and reduced credit rating at NUI Corp., which pulled down NUI Utilities' credit rating along with its own. Moody's has decreased NUI Utilities' credit rating from the A3 level all of the way to the Ba3 level, six total ratings notches, in five separate ratings downgrades from September 2002 to the CSFB refinancing. Moody's has been clear in its reasoning for these decreases. Specifically, Moody's noted that its NUI Utilities' rating actions reflects Corp.'s unregulated business losses and the common management of NUI Utilities' financials and treasury operations with those of NUI Corp.

Moody's also specifically and several times cited the free flow of funds across business lines and the sharing of central services. Moody's also specifically stated in its October 6, 2003 downgrade of NUI Utilities that NUI Corp. owed Utilities a significant sum; *i.e.*, the inter-company balance. The reporting of NUI Corp. financial results on a consolidated basis has the effect of "zeroing" out the sums owed and due among affiliates.

NUI Utilities has posted consistently solid financial results and credit statistics during the period of these downgrades. NUI Utilities' downgrades are therefore very clearly the result of poor financial performance by non-utility ventures, and more particularly the financing and support that has accrued to them because of the structuring of NUI Utilities credit agreements and the free flow of funds among all NUI entities.

NUI Utilities' own financial results and credit ratings statistics have remained strongly at levels that would independently support investment grade ratings throughout NUI Corp.'s overall financial struggles. The credit rating agencies rely on four key credit rating ratios for statistical analysis in evaluating the financial strength of entities that they rate. These four credit rating criteria consist of:

- Total debt to total capital percentage
- Pre-tax interest coverage
- Funds flow from operations as a percentage of total debt
- Funds from operations interest coverage.

NUI Utilities sat in the "BBB" range with respect to the total-debt-to-total-capitalization criterion from 1998 through 2001, and the "A" range in 2002 and 2003. NUI Utilities pretax interest-coverage measurement fit the "A" range from 1999 to the present. NUI Utilities funds-from-operations-to-total debt factor qualified for the "BBB" range from 1998 through 2001, and it improved to the "A" range in 2002. NUI Utilities' funds flow from operations interest coverage metric has been solidly in the "A" range since 1999.

B. Summary of Financial Results and Credit Ratings Conclusions

1. NUI Utilities, and in particular ETG, have remained consistently and solidly profitable across at least the past six years, while NUI's non-utility businesses have recorded crippling financial losses, which became apparent starting in 2001.

2. No aspect of NUI Utilities/ETG performance on stand-alone bases contributed to NUI Corp.'s financial distress, nor is there reason to believe that utility operations would have had financial problems absent affiliation with poor performing non-utility businesses.

3. NUI Utilities' credit rating declines to below-investment-grade level were specificaly due to financial problems at NUI's non-utility entities and NUI's financial management.

4. NUI Corp. assigned all of the proceeds of a 2002 corporate stock issuance to ETG, in advance of a rate filing; the cash was never in effect available to ETG, but was used to fund non-utility operating losses and investments.

5. The capital structure on which ETG based its last rate filing before the NJBPU did not bear a reasonable resemblance to what existed before and shortly after the proceeding.

6. The write-down of NUI Utilities' equity due to the PricewaterhouseCoopers' Utilities audit caused NUI Utilities/ETG's equity levels to vary from good utility practice, but closing of the CSFB refinancing provides an opportunity for remedying this situation.

7. NUI Utilities would have maintained a strong, investment grade credit rating if it had been properly insulated from NUI Corp.

C. Cash Pooling

There existed at NUI Corp. prior to September 2003 a single corporate cash pool for the holding company and for all of its subsidiaries and business units, both utility and non-utility. ETG's revenue flowed into this single NUI cash pool, or bank concentration account, along with all other utility revenue and receipts. The receipts of NUI Corp., NUI Capital, and its non-utility businesses also flowed into this same, single pool. Disbursements to employees, vendors, and lenders of all NUI companies also came from this single, common NUI pool. NUI allowed funds to transfer freely from one NUI affiliate to the other. There existed no loan or similar documents or agreements to govern such transfers.

NUI's pooling of all cash in one bank concentration account resulted in an inappropriate commingling of funds between utility and non-utility operations and entities. This situation allowed NUI's non-utility businesses continually to secure funding from the single corporate cash account, which was tapped to pay invoices for all NUI companies.

Another crucial shortcoming related to the pooling of funds is that NUI did not settle balances between companies on a regular basis. The Company generally allowed these balances to accumulate over a period of two to five years to amounts that were immense for an enterprise of NUI's size. The inter-company payable from NUI Corp. to NUI Utilities was allowed to grow to $190 million by March 2003. The relative magnitude of this amount stands in stark relief when compared against the total equity capital of NUI Utilities, which is only about $270 million. Only in early to mid-2003 did NUI begin to recognize, document, and start to address the inter-company balance.

NUI also failed to set up loan agreements between affiliate companies to govern ongoing inter-company transfers of cash caused by the single cash pool. As a result, the "lending" affiliates in inter-company cash transactions were not provided with even the simplest lending protections to help ensure repayment. No loan terms, covenants or security interests were provided to the affiliate "lenders," even as outside lenders moved emphatically to install such protections in connection with their loans as NUI's non-utility performance and financial condition deteriorated.

D. Summary of Cash Pooling Conclusions

1. NUI Corp. effectively required NUI Utilities to make loans to affiliates that no reasonable lender would have considered, even before considering a proper interest rate; these loans came at less than arm's-length and they were unreasonable on their faces.

2. Management's failure to adopt prudent practices and protections for credit agreements and receivables balances put NUI Utilities, as an NUI Corp. creditor, at considerable disadvantage when compared to NUI's outside creditors, in recovering funds lent.

3. With the BPU's 2001 approval of the NUI holding company and the creation of NUI Utilities, NUI Corp. should have segregated its cash management systems, restricted or prohibited inter-company transfers and loans, and set in place specific procedures and rules for the settlement of inter-company balances; it failed, however, to take actions reasonably necessary to comply with the BPU order.

4. The failure to set up systems and safeguards caused establishment and growth of huge inter-company balances between affiliates; the primary lender, NUI Utilities, found itself in a subordinate position to be repaid in comparison to the claims of outside creditors.

E. Credit Facilities Usage

Prior to establishing the holding company in March 2001, NUI Corp. provided funding for utility operations by borrowing from its various lines of credit and down-streaming the funds for utility use. This credit structure changed in December 2001, with the establishment of a revolving line of credit for NUI Utilities. On December 19, 2001, NUI

Corp. established a $145 million line of credit for NUI Utilities with a group of banks. At the same date, NUI Corp. replaced its then-existing $232.5 of short-term borrowing at the parent level with a much smaller, $80 million revolving line of credit. The same group of banks provided both the new NUI Utilities line of credit and this replacement, $80 million line of credit for NUI Corp. The net change in total committed credit to NUI at the holding company-wide level was a reduction of $7.5 million, which consisted of:

- Eliminating existing $232.5 million of short-term debt financing at NUI Corp.
- Replacing it with a total of $225 million
    - $145 million in the name of NUI Utilities
    - $80 million in the name of NUI Corp.

The entire amount of the NUI Utilities' $145 million of available credit was immediately drawn down and placed in the NUI Corp. cash pool. NUI Corp. then immediately used funds from the cash pool to pay down NUI Corp. short-term borrowings. According to NUI's current controller, $145 million of short-term debt, which existed previously as a liability of NUI Corp., moved to NUI Utilities at this time. The cash from the short-term borrowings, however, did not also move from NUI Corp. to NUI Utilities. Effectively, the NUI Corp. short-term debt was "reassigned" to NUI Utilities by the establishment of the NUI Utilities revolving credit and the concurrent extinguishment of $145 million of short-term debt at NUI Corp.

At November 30, 2001, NUI Utilities owed NUI Corp. a payable of $61.2 million. With the "reassignment" of $145 million in short-term debt to Utilities, this payable balance reversed, and became a receivable balance of $40.1 million at December 31, 2001. The receivables balance for Utilities did not fall below $54.7 million from the end of 2001 until repayment after the November 2003 CSFB refinancing. It reached a peak of $190.1 million at the end of February 2003.

As of the end of June 2003, Utilities had $123.9 million outstanding on its line of credit and NUI reported that the payable from Corp. to Utilities was $111.5 million at the same date. NUI Corp.'s net cumulative investment in its non-regulated companies stood at $164.9 million as of this same date.

Since the establishment of a separate NUI Utilities revolver, there has been little correlation between the debt outstanding and NUI Utilities needs, unless one considers the amount that NUI Utilities made available for non-utility use. The following table demonstrates the very strong correlation between the intercompany receivable due to NUI Utilities and the amount that NUI Utilities borrowed against its revolver. In other words, had there been no substantial intercompany receivables balance, NUI Utilities working capital needs would have been drastically smaller.

Table IV.3. Correlation Between NUI Utilities Credit Usage and Intercompany Receivable

Month End	Revolving Credit Used	Payable to NUI Utilities	Actual Needs	Affiliate Credit Use
Dec 01	145.0	40.1	104.9	28%
Jan 02	145.0	56.6	88.4	39%
Feb 02	125.0	56.5	68.5	45%
Mar 02	87.0	82.6	4.4	95%
Apr 02	60.0	75.1	-15.1	125%
May 02	57.0	56.6	0.4	99%
Jun 02	60.6	58.7	1.8	97%
Jul 02	52.1	54.8	-2.7	105%
Aug 02	74.8	58.3	16.5	78%
Sep 02	63.7	60.8	2.9	95%
Oct 02	69.7	75.9	-6.2	109%
Nov 02	111.9	113.5	-1.7	101%
Dec 02	110.0	119.1	-9.1	108%
Jan 03	140.0	167.9	-27.9	120%
Feb 03	141.9	190.1	-48.2	134%
Mar 03	140.3	168.4	-28.0	120%
Apr 03	115.5	150.5	-35.0	130%
May 03	126.9	150.2	-23.3	118%
Jun 03	123.9	111.5	12.4	90%
			Average	97%

F. Summary of Credit Facilities Usage Conclusions

1. NUI Corp. has clearly been using NUI Utilities' funds from its revolving line of credit and operating receipts to fund the holding companies' non-utility investments and operations.

G. Joint Credit Negotiations

With the establishment of the holding company, the assignment to NUI Utilities of the responsibility for conducting utility operations, and the formation of a separate NUI Utilities line of credit in 2001, NUI had an opportunity to structure separate lines of credit, lenders, and cash management operations for utility operations and for its far riskier non-regulated operations. Instead of providing for clear separation, however, NUI tied NUI Utilities' lines of credit to those of NUI Corp., NUI Capital, and the non-utility businesses through the joint negotiation of parallel credit agreements with common lenders. The lenders to NUI Corp. and NUI Utilities under the December 2001 and February 2003 revolving credit agreements were identical for each respective pair of agreements.[10] The agreements are signed as of the same date, by the same parties, and were obviously negotiated jointly. Each of the four amendments to the December 2001 credit agreements were also as of the same day for both Corp. and Utilities.

[10] There were a few subsequent assignments involving some of those lenders.

When problems at non-utility entities and the three-year re-audit of NUI Corp. financials in 2002 caused technical defaults on the NUI Corp. revolving credit agreement, both NUI Corp. and Utilities' credit agreements were simultaneously amended by NUI and lenders. These amendments made the Utilities' credit agreement measurably more expensive, even though the defaults were caused entirely by failures at NUI's non-utility businesses.

H. Summary of Joint Credit Negotiation Conclusions

1. For NUI to allow NUI Utilities' lines of credit to be tied to the non-utility businesses through jointly negotiating lines of credit was a poor management decision, because it violated the standards of the holding company order and of good utility practice.

2. The actions that caused a failure of separation have done severe damage to the capital access of the utilities; NUI has seriously damaged NUI Utilities` access to working capital, and very substantially increased the cost of such capital by tying the sources and negotiations for regulated and non-regulated funding together.

3. If NUI Utilities and NUI Corp. finances had not been inseparably linked by management and lenders, the poor performance of NUI's non-utility operations would have caused increased financing costs to NUI Corp. and it would have earlier lost the ability to continue funding non-utility investments and operating losses.

I. Cash Management Re-Engineering

A provision of the NUI Utilities' 2003 revolving line of credit agreement requires that the cash management system for NUI Utilities be segregated from that of NUI Corp. by November 12, 2003. NUI began restructuring its cash management system in April 2003, in order to segregate the funds of NUI Utilities and NUI Corp. The goal of this cash management re-engineering was to create transparent and segregated cash systems that would meet the specific needs of NUI lenders. NUI set forth in April 2003 the following project goals for the re-engineering of its cash management system, which it originally scheduled for completion by June 30, 2003:

- Separate cash management for NUI Utilities and NUI Corporation
- Solicit and select new bank vendors
- Simplify the bank accounting structure
- Separate NUI Utilities actions from other NUI actions
- Re-engineer the cash processes and procedures
- Ensure cash security control and timely recording into the general ledger
- Tighten depository control of cash
- Ensure control of cash by the unit
- Improve internal controls
- Coordinate cash accounting efforts through completing timely bank-to-book reconciliation
- Reconcile the general ledger to sub-ledgers
- Develop cash flow forecasts and models by business unit
- Develop effective liquidity forecasts

- Separate NUI and NUI Utilities forecasts.

NUI completed principal work on the segregation of its cash management systems in September and October 2003. NUI has had very substantial difficulty in developing an accurate cash flow forecast, however.

Liberty performed a review and analysis of the progress made by NUI, and tested the separation of the cash pools against the following three overall standards:

- Separate cash management for NUI Utilities and NUI Corp.
- Ensure cash security control and timely recording into the general ledger
- Settle intercompany accounts payable and receivable balances on a timely basis.

Liberty examined both the NUI Corp. and NUI Utilities cash pools. Liberty specifically focused on the cash balances for August 2003. The year-end closing process then underway made August the last month for which books had been closed at the time of Liberty's test work.

NUI chose Fleet Bank as the primary cash management bank for both NUI Corp. and NUI Utilities. The bank accounts have been reengineered and structured in a distinct and deliberate manner to capture both the corporate and business unit structures within each of the two cash pools.

J. Summary of Cash Management Re-Engineering Conclusions

1. NUI has adopted a cash-management structure and process whose design provides appropriately for the separation of utility and non-utility cash.

2. NUI has begun to operate under the new segregated cash-management structure, but has not yet formally adopted its cash management agreement.

3. NUI management should take the appropriate steps to complete its final review and approval of the cash management agreement, and to complete the development of a number of new bank-account controls.

4. NUI has established and has very recently begun using a cash forecasting model that should effectively separate the cash and liquidity status of NUI Utilities from non-utility operations.

K. Long-Term Debt

Only two NUI entities issue long-term debt financing for NUI Corp. and its subsidiaries: NUI Utilities and NUI Corp. NUI Utilities issues long-term debt to provide permanent financing for ETG, CGF, and Elkton. At June 30, 2003, NUI Utilities had $250 million of long-term debt outstanding. NUI Corp. issues long-term debt financing for the holding company and non-utility affiliates. NUI Corp. had $60 million of Senior Notes outstanding at June 30, 2003. The NUI Corp. note purchase agreement (for the $60 million of senior notes) dated August 20, 2001 restricts the financing activities of NUI

Utilities significantly. Section 10.9 of this agreement establishes the ability of NUI Corp. creditors to inhibit the ability of NUI Utilities to grant security interests to creditors in connection with Utilities' financing.

Other covenants of the NUI Corp. senior notes also restrict the activities of NUI Utilities. For instance, Section 10.6 prohibits any restricted subsidiary, including NUI Utilities, from providing any guaranty of any obligations. Section 10.7 of the agreement does not permit ETG or CGF to enter into any agreement that would restrict the ability of these companies to pay dividends to the parent. Section 10.8 of the agreement limits the sale of assets of restricted subsidiaries, including NUI Utilities, to 15 percent of NUI's consolidated total assets.

NUI proposed an overall refinancing of both NUI Utilities and NUI Corp. to the NJBPU on August 20, 2003. The proposal as it related to NUI Utilities included the following components:

- A term loan with a three-year maturity and secured by property, plant and equipment to extend the maturity of existing debt and provide additional dollars for capital investment
- Restructuring a portion of $200 million gas revenue bonds to take advantage of current lower interest rates
- A secured revolving credit facility to support utility operating requirements, secured by NUI Utilities' property, plant and equipment.
- An accounts receivable securitization at NUI Utilities to support working capital requirements.
- An interim liquidity facility to satisfy peak winter gas supply requirements of NUI Utilities.

Liberty raised a number of significant concerns to NUI about its extensive refinancing plan. First, the proposed securitization of NUI Utilities' assets in order to acquire financing should not have been required. A stand-alone NUI Utilities would have been able to raise financing based on its own credit at a reasonable rate and without securitizing its assets to a group of NUI Corp's existing creditors.

NUI's refinancing plan also proposed that NUI Corp.'s creditors receive a pledge of NUI Utilities' common stock as security for their loans. Such a pledge of NUI Utilities' common stock would allow NUI Corp.'s creditors potentially to gain operating control of the utility. Providing access to an operating utility by an entity whose interests focus on debt repayment is clearly contrary to good utility practice and sound regulatory policy.

The financing proposal was also inappropriately sized as between NUI Corp. and NUI Utilities. The August proposal included $300 million of total financing for NUI Utilities, and only $105 million for NUI Corp. The August proposal would not have provided sufficient funding for NUI Corp. to pay back the inter-company payable balance to Utilities, and would have raised excessive levels of funds with NUI Utilities as the obligor. The significant imbalance of this proposal is evidenced by the size of the recently completed CSFB financing, which included $255 million of financing for NUI Cop. and only $150 million for NUI Utilities.

L. Summary of Long-Term Debt Conclusions

1. NUI Utilities has lost the financing and operational flexibility that is consistent with good utility practice, as a result of NUI Corp. senior notes, which contain limitations and restrictions whose purpose is to provide support (in terms of a backstop cash source) from NUI Utilities to the credit and financing of NUI Corp.

2. A 2002 technical default on the NUI Corp. senior notes caused difficulty and additional cost in renegotiating Utilities' revolving line of credit in early 2003. NUI was forced to enter negotiations with the senior note holders and the bank lenders to NUI Corp. and to NUI Utilities to resolve the senior notes default. These negotiations produced an increase in the interest rate on Corp.'s senior notes, additional security provisions for the senior note holders, and higher interest rates on both NUI Corp. and NUI Utilities revolving lines of credit.

3. NUI's lack of adequate attention to the specific provisions of its outstanding financing agreements and its negotiation of new financing facilities caused the technical default on the senior notes in 2002, and the curing of the default produced an increase in financing costs to NUI Utilities in 2003.

4. The refinancing plan that NUI proposed in August 2003 was unsound and contrary to the goals of the holding company order for many reasons: it was proposed without pursuit of other options, it would have further tied NUI Utilities' financing to Corp., it would have pledged utility assets and common stock to NUI Corp. creditors, and it was in gross disproportion as between NUI Corp. and NUI Utilities.

M. Recent Developments

Liberty began the focused audit of NUI in June 2003. Since this time, NUI management has made a number of proposals on refinancing the company, liquidating non-regulated businesses, recognizing and setting forth plans to repay the inter-company payables balance, and bolstering the deteriorating liquidity position of the company. In late September 2003, NUI announced that its Board of Directors had decided to sell the company, which it said would address all of these issues.

1. Reorganization and Recognition of the Inter-company Balance

On July 16, 2003, an NUI Corp. management presentation to the NJBPU first recognized many of the financial and regulatory problems that faced the company. In its presentation, NUI recognized the failure of most of its non-regulated businesses, and the negative impact of the PWC three-year audit and the four (at that time) Moody's credit rating downgrades. NUI reported that the company was "reorganizing", and revising its strategic focus, with the following key initiatives:

- Implement new cash management and accounting controls
- Produce separate audited financials for NUI Utilities

- Strengthen internal controls
- Dispose of non-core businesses
- Restructure short and long-term financing
- Settle the inter-company balances
- Revise the corporate structure.

Key stakeholders forced most of the proposed NUI initiatives upon the company. The first two mentioned above were required by NUI's bank lending group. The next two were strongly suggested by public ratings actions by Moody's, which rates company debt. Restructuring NUI financing would be required before the end of 2003 to avoid probable defaults on existing debt covenants. This presentation was the first to reveal the magnitude of the inter-company balance to the BPU.

NUI reported on July 16, 2003 a payable to NUI Utilities of approximately $112 million as of June 30, 2003. This "net balance" included payables of NUI's non-regulated business to NUI Utilities of $164.9 million. NUI disclosed later, on July 24, 2003, that the net balance would have been $144 million if a $31.9 million, retroactive and non-cash dividend had not been recorded from ETG to Corp. the previous month. NUI also reported that the company was exiting the NUI Energy and NUI Environmental businesses, and had hired an investment advisor to provide "strategic alternatives" for UBS and NUI Telecom.

In the weeks following this presentation, NUI management set forth a plan for paying back the inter-company payable to NUI Utilities by June 30, 2004. This plan would use the proceeds from the sale of non-utility businesses and residual assets to pay down part of the inter-company balance, with the rest to be paid by June 30, 2004. NUI relied upon this plan a number of times in interviews with Liberty.

2. Asset Sale Plans

NUI presented, but quickly dropped the Fleet refinancing proposal made on August 20, 2003. Management also discussed with Liberty a variety of proposals for securing the resources needed to satisfy the intercompany balance and for restoring financial stability to NUI Corp. and to NUI Utilities. These plans focused upon the sale of limited portions of NUI's assets, some of them utility and some of them non-utility in nature. Liberty found these partial sales packages to be unrealistic in terms of the valuations being used and in terms of the execution risks that they presented. In the meantime, there remained a looming short-term liquidity crisis potential, along with a longer-term, similar potential, should NUI not be able to find a way to replace credit capacity prior to the expiration of the NUI Corp. and NUI Utilities revolving credit agreements in February 2004.

NUI management decided in mid-September 2003, that the solution to NUI's financial predicament and the satisfaction of the needs of all of its stakeholders lay, not in the ineffective options presented before, but in selling the entire corporation. This option, in distinction to the others on which management had been persistently focusing, presented an option with sufficient apparent executability in the time required to monetize the value of sufficient assets in order to pay NUI Corp. creditors, deal with the revolving credit facilities, and pay to NUI Utilities the inter-company payable balance.

3. 2003 Liquidity Position

One of Liberty's primary concerns in the early stages of the focused audit was NUI's liquidity position and ability to purchase gas for its utility customers. Liberty requested a special meeting with the NUI CFO and treasury management on July 8, 2003 to discuss these issues. NUI assured Liberty at this time that the existing lines of credit were adequate for the summer storage filling season, and that an additional line of credit was being arranged that would cover all winter season contingencies, including higher gas prices for the coming winter. This credit facility was to be in place in "one or two weeks" as of the July 8 meeting.

An important tool for efficient financial management in a utility is its cash forecast. For a utility experiencing financial and credit problems such as NUI, the cash forecast becomes critical on a day-to-day basis. NUI was not using one at the outset of Liberty's audit, and NUI management indicated that it had not had even an analytically based cash forecasting tool in operation within the memory of current financial management. The absence of cash forecasts became increasingly problematic for NUI as the company neared its borrowing limits in the summer of 2003. The summer is normally the period of lowest borrowing requirements for a gas LDC.

NUI had included the development of cash forecasts for NUI Corp. and Utilities as part of its project to re-engineer and segregate the company's cash management system. However, the development of cash forecasts was the last major item to be addressed by NUI in the re-engineering project. The development of the cash forecasts eventually proved to be quite problematic, as Liberty's observation of progress during the audit demonstrated.

NUI management reported that the June 2003 borrowing peak for NUI consolidated had reached \$175 million, and for July 2003 about \$176 million. With a total consolidated borrowing limit of \$180 million, NUI was nearing its borrowing limits in the middle of summer. This situation was of great concern, as NUI Utilities' borrowing needs generally increase as the utility pays for gas purchases in the September-January period.

NUI provided Liberty with early liquidity analyses, which were dated July 30 through September 19, 2003. These "developmental" versions of the cash forecast indicated that NUI could exceed its \$180 million credit limit when peak-day borrowing occurred, as early as September or October 2003. These initial liquidity forecasts indicated that NUI's much-delayed liquidity line of credit (initially expected to be in place in mid-July) could be needed immediately.

NUI eventually proposed to manage around its September and October peak borrowing days by carefully scheduling receipts and disbursements on the monthly gas-settlement day, when borrowing is at peak levels. The cash forecasts produced in September also included an immediate phasing down of the business of Energy Brokers, which requires substantial credit availability to operate. Even that phase-down does not eliminate potential problems, because collateral calls by counterparties even under existing, longer-term Energy Broker's transactions can be substantial.

NUI Utilities finally closed on a $50 million liquidity line of credit with Drawbridge Special Opportunities Group in October 2003. Drawbridge provides capital to distressed companies, and the fees and interest rates of the credit facility were exceedingly expensive for a utility. No borrowings were made under that facility.

On or about October 1, 2003, NUI brought in "corporate recovery" consultants to manage the financial operations of the company. The consultants' first priority was to develop a 13-week liquidity forecast to provide accurate cash information. Such information is crucial in managing a financial crisis and turnaround. The consultants described their work as requiring a substantial recreation of much of the data and analysis previously gathered in NUI's attempts to develop a cash forecast. As Liberty's own observations of earlier forecast runs demonstrated, the consultant's work determined that information in the previously released forecasts was not reliable.

The consultant's new liquidity forecasts were shared with Liberty in late October 2003. The new forecasts indicated that NUI Utilities would have ample line of credit availability during the 2003/04 winter with the $50 million Drawbridge facility, assuming average weather as measured over the past 10 years. NUI uses such average weather in preparing its budgets and forecasts. Only under the most extreme conditions, such as the coldest winter in the last 50 years, would the existing credit lines be insufficient, according to NUI's consultants.

By early September 2003, Liberty found numerous reasons for doubting NUI's ability and resolve to protect the financial viability of the utility operations. The following issues exemplify the basis for such doubts:

- *Liquidity Issues* – As described above, NUI management had initially reported that an additional liquidity line of credit for Utilities of $50 million would be in place in mid-July 2003. By early September, this line of credit was still not in place, because NUI was having obvious difficulty in finding interested lenders. NUI's own liquidity forecasts, which were still being developed, indicated that the company would exceed its existing lines of credit in September, October, or December, depending on the version.

- NUI's liquidity forecasts also indicated that one of the actions taken to reduce its overall borrowing needs was to drastically curtail the operations of Energy Brokers. As Energy Brokers had been one of NUI's few profitable non-utility operations, its sudden demise was an additional indicator of distress.

- *Inter-company Balance Repayment Plan Issues*: Liberty believed that NUI's communicated plan for the repayment of the inter-company payable was not feasible. The sales of UBS and Telecom and NUI Energy's accounts receivable collections comprised $51 million of NUI's repayment plan. However, NUI Corp.'s revolving credit agreement specifically required that the proceeds of sales of equity or assets in NUI's subsidiaries (except for Utilities and Virginia Gas) were to be used to pay down the Corp. revolving credit facility.

- According to NUI management, the company had asked Fleet Bank to waive this provision. However, Fleet did not provide this approval, and would only provide such approval as part of the overall refinancing plan, which would securitize NUI Utilities assets.

- NUI also proposed to use $20 million of "cash on hand" to pay down the inter-company balance. However, NUI's liquidity forecasts at that time did not indicate that sustained cash would be available in the immediate future. In addition, until the cash management systems were segregated and audited, it would be uncertain whether such cash would belong to Corp. or Utilities.

- NUI did not provide a source for the final $27 million of repayment in 2004. This repayment also seemed improbable, because NUI planned to sell or shut down UBS and Energy Brokers, its primary sources of non-regulated income.

- *Refinancing Plans*: NUI's refinancing plans were not acceptable, and the refinancing business was to be arranged by Fleet Bank on a sole-source basis.

4. NUI Sale Announcement

The NUI CFO acknowledged in an interview on September 10, 2003 that NUI was working with an investment banking advisor in analyzing the potential sale of parts or all of NUI Corp. On September 25, 2003, NUI announced that the entire NUI Corp. would be offered for sale. Following the announcement of the sale of NUI Corp., the opportunity was presented for NUI to obtain interim financing for the entire company that would meet all funding needs until the closing of the sale. The closing of the NUI Corp. sale, allowing for the sales process and all required regulatory approvals, is expected to require 9 to 15 months from the hiring of advisors to handle the sale.

NUI entertained proposals from several investment banking firms interested in running the sales process. NUI also discussed with these firms and other funding sources potential interim financing until closing of the sale. NUI selected Credit Suisse First Boston to co-manage the sale of NUI, along with Berenson, NUI's existing financial advisor. Credit Suisse First Boston also proposed a major refinancing through a syndication of lenders. On November 24, 2003, NUI Corp. and NUI Utilities closed on a $405 million package of credit facilities with CSFB. The credit facilities provide maximum financing levels of $255 million to NUI Corp. and $150 million to NUI Utilities for 364 days, extendable for two 180-day periods.

CSFB's "interim financing package" will provide funding for the entire NUI holding company at levels that would meet all projected funding and financing needs until the closing of the sale of the company. The closing of the NUI Corp. sale, allowing for the sales process and all required regulatory approvals, is expected to require 9 to 15 months. The anticipated monetization of the equity value of NUI through the sale of the company provides CSFB's expected future and final source of repayment for the NUI Corp. debt. The following paragraphs summarize the components of this refinancing.

NUI Corp. – $255 million Term Loan: NUI Corp. entered into an unsecured Term Loan with CSFB for $255 million with an initial term of 364 days. NUI Corp. has the option to extend the term loan for two 180-day periods for a 50 basis point fee for each extension. NUI Corp. must pre-fund the estimated interest payments for the first 364 days in an escrow account from a portion of the financing proceeds. If the Term Loan is extended, the estimated interest during the extended period must also be placed in escrow. The proceeds of the term loan are expected to be used by NUI Corp. as follows:

- Repayment of NUI Corp. Revolving Credit Agreement: $38 million
- Repayment of NUI Corp. million Senior Notes and prepayment premium: $72 million
- Funding of 12 months of interest on term loan: $20.4 million
- Repayment of Inter-company Balance to NUI Utilities: $85.0 million
- Payment of fees and "General Corporate Purposes:" $39.6 million.

NUI Corp. paid CSFB a 3 percent arrangement fee at closing. The interest rate on the term loan is the Euro-Rate with a 2 percent floor plus 6 percent (or an alternate base rate plus 5 percent). The initial interest rate on the facility is 8 percent, which produces an initial total cost of financing of over 11 percent.

The key provisions of the NUI Corp credit agreement with CSFB are as follows:

- The ratio of total indebtedness (short and long term) to total capitalization for Corp. cannot exceed 75%
- Corp.'s ratio of EBITDA/Interest expense cannot be less than 1.75:1
- Corp. may keep (*i.e.*, not be required to apply to loan repayment) up to $20 million of net proceeds from sales of assets such as UBS or NUI Telecom
- Corp. can dividend up to $20 million to its shareholders, unless an event of default is caused or a Governmental Rule (such as an NJBPU Order) is violated
- A default is caused by any fines or penalties in connection with the Focused Audit in an aggregate amount of $25 million or more.

NUI Utilities - $150 million: NUI Utilities entered into a three-part credit agreement with CSFB for a total of $150 million. The credit agreement includes a $50 million unsecured Term Loan and a $50 million revolving line of credit, each of which has an initial term of 364 days. NUI Utilities also has options to extend these two facilities for two 180-day periods, which will require a 50-basis-point fee for each extension. The proceeds of the Term Loan and an $85 million repayment of the inter-company payable from NUI Corp. will roughly allow the payoff and termination of the existing Utilities revolving line of credit with Fleet Bank. The new revolving credit facility replaces the recently arranged Drawbridge $50 million liquidity line of credit to finance the working capital and gas purchasing needs of NUI Utilities. Moody's has issued a rating of Ba3 on these financings, which reflects the total of six ratings levels lost in five separate ratings actions since September 2002.

A third $50 million financing facility is called the Delayed Draw Term Loan. This term loan may be drawn before November 22, 2003 and is to be used solely for the purpose of paying the maturity of Utility's $50 million of Medium Term Notes on February 1, 2005. A 50 basis point fee would be paid to exercise this option.

NUI Utilities has paid an arrangement fee to CSFB of 3 percent at closing. A commitment fee of 0.625 percent on the unused portion of all three of the financing pieces also will apply. Interest rates on the Utilities financings are either the Euro-Rate with a 2 percent floor plus 5 percent or an alternate base rate plus 4 percent. Either alternative would result in an initial 7 percent interest rate, which will produce an initial total cost of borrowing of over 10 percent annually. By comparison, an investment-grade utility should be able to borrow working capital funds for about 2.0 percent as of November 24, 2003.

The key provisions of the Utilities credit agreement with CSFB are as follows:

- The ratio of total indebtedness (short and long term) to total capitalization for Utilities cannot exceed 70%
- Utilities' ratio of EBITDA/Interest expense cannot be less than 2.25:1
- Utilities can dividend up to $35 million to NUI Corp., unless an event of default is caused or a Governmental Rule (such as an NJBPU Order) is violated
- A default is caused by any fines or penalties in connection with the Focused Audit in an aggregate amount of $25 million or more.

N. Summary of Conclusions about Recent Developments

1. NUI's August 20, 2003 refinancing plan did not provide an appropriate structure or sufficient funds to NUI Corp. to meet the holding company's liabilities, especially the intercompany payables balance to NUI Utilities.

2. The sale of NUI's non-regulated businesses, as originally proposed by NUI, would not have provided sufficient funds to pay both NUI Corp. creditors and the inter-company balance.

3. A potential liquidity crisis for NUI Utilities in the winter of 2003-2004 was avoided only with extremely high-cost credit facilities.

4. NUI did not have critical cash forecasting tools in place when it faced liquidity crises in 2002 and 2003.

5. The only feasible solution to NUI's inter-company balance payback and revolving credit renewal issues was to monetize the equity value of the whole company through the sale of NUI Corp.

6. The CSFB interim financing package for NUI provides the best available financing bridge to the sale of the company, but came at costs very much higher than NUI Utilities' own financial characteristics should have required.

V. Accounting and Controls

A. Background

Observations about a lack of adequate controls at NUI have formed a major part of the problems that led to downgrades in the credit ratings of the parent and NUI Utilities. The company has recognized the need to address controls weaknesses; it has been undertaking programmatic efforts to address them. Much of those efforts are now complete. Liberty's work focused on identifying the kinds of weaknesses that led to these observations and on the actions being taken to address them. Liberty examined the account structure and systems, and looked at prior audit work and current company plans and actions to address key accounting systems, including accounts payable and receivable, payroll, work orders, and continuing property records. The BPU asked that this focused audit address all of them.

The primary issue of concern that Liberty found was the treatment of intercompany balances and receivables. The preceding chapter of this report describes Liberty's examination of credit and finance issues. That chapter addressed how the use of a common cash pool and the failure to segregate the finances of NUI Corp.'s non-utility businesses and ventures, on the one hand, and NUI Utilities, on the other hand, produced extraordinary and inappropriate amounts of money owed to NUI Utilities. Liberty's audit work addressing accounting and controls addressed a related but distinct set of questions; in particular, it examined the degree to which accounting for these balances made them sufficiently visible within the Company and to the BPU.

B. Account Structure and Systems

The NUI accounting system operates on the basis of collecting accounting information from the NUI business units through various feeder groups. NUI then enters this information into a financial system known as "PeopleSoft." This system provides the primary central collection process. NUI uses it to develop routine financial statements, to support special queries for data or analysis, and to generate routine and special reports and analyses. NUI has adopted a chart of accounts that is based upon the FERC USofA. Earlier NUI business ventures primarily included businesses under state utility regulatory jurisdiction, which made this system sound as an accounting framework. This chart of accounts, with minor additions, proved easily adaptable to the new businesses, which included non-utility operations.

Prior to January 2003 the controllers in each business unit reported to the head of that business unit. NUI has corrected this weakness in the organizational accounting structure; as of January 2003 the business unit controllers began to report directly to the NUI Corporate Controller.

Liberty's analysis of the chart of accounts, the general ledger, and sub ledgers demonstrated that separate accounts are adequately maintained for each business unit. Additionally, each unit maintains sufficient general ledger intercompany balances of payables/receivables between each respective business unit. NUI, however, did not limit intercompany balance recording to what would traditionally be considered to be goods and services. NUI puts into the same accounts the results of transactions related to its single cash pooling arrangement; *i.e.*, financial transactions.

C. Policies and Procedures

NUI Corporation has acted as agent for the business units, including ETG, and has coordinated daily cash receipt and disbursement since 1990. It had no written policy to guide these cash pooling actions. Liberty would have expected to see a formal cash-management agreement clearly setting forth the terms and conditions under which services would be provided. The results of NUI's cash management practices included:

- A balance payable from NUI Corp. to NUI Utilities of $61.4 million as the end of the September 30, 2002 fiscal year
- Growth in that balance to $190 million as of February 2003
- A large decline to $95.5 million as of August 30, 2003.

The internal controls within the various accounting functions involved at UBS and NUI provide critical links in assuring sound performance. Liberty found formal policies and procedures to be non-existent during most of the past 10-12 years. As Liberty's audit has progressed, NUI has corrected many of these deficiencies. Bank reconciliations are now routinely being performed monthly. NUI's single cash pool is being divided into two cash pools -- one for NUI Utilities and another for NUI Corp. and its remaining subsidiaries. Liberty has tested changes to the cash separation process, and has reviewed the two cash pools to verify separation, as well as the bank reconciliation process. Liberty's testing found them to be generally sufficient. Formal policies and procedures within the Treasury department, however, are only in the developmental stage at this time. They require completion and formal documenting.

NUI has a company-wide formal procedure for purchasing and accounts payable and receivable. Further discussion of these items appears below in this chapter of the report.

D. Intercompany Balances

NUI Corp. performs external financial reporting on a consolidated basis, which means that the Company excludes intercompany accounts payable and receivable balances from such reports. However, NUI Utilities operates ETG as a regulated utility under the jurisdiction of the BPU, which requires use of the FERC Uniform System of Accounts prescribed for Natural Gas Companies subject to the provisions of the Natural Gas Act. ETG must file with the BPU an annual report similar to FERC Form 2.

These transactions and the sum of any monies payable to or receivable from each of the business units must be accounted for and appropriately reported from a cost-accounting perspective. Of particular note was NUI's use of a single cash pool arrangement, in which all of its business units participated. Additionally, NUI maintained short-term debt instruments at the parent level for some time; NUI Utilities obtained separate short-term debt instruments somewhat more recently. The funds of NUI Corp. and of NUI Utilities were available to finance the operations of all of the individual business units. These transactions and the sum of any monies payable to or receivables from each of the business units must be appropriately accounted for and reported as intercompany transactions in the accounts payable and accounts receivable process.

A number of non-utility affiliates did little if any direct business with NUI Utilities, but came to owe NUI Utilities a total of over $157.9 million as of August 30, 2003.[11] The funds provided by NUI Utilities to these entities have been provided to cover the operating losses and investment needs of these businesses; *i.e.*, to provide them ongoing access to capital, much as banks would.

Liberty attempted to gather data that showing how and for what specific purposes the intercompany receivables accounts have grown over time. Liberty has raised the issue on multiple occasions through data requests and at interviews. NUI did provide earlier in the audit a very long list of general ledger entries that combined to produce the balances. The following NUI response characterizes the level and quality of information that Liberty had until very recently:

> *These intercompany payable balances on the books of the non-regulated companies were generated over many years of the operations of these companies. They generally represent funds advanced for working capital needs and to finance capital expenditures.*

This response suggests that ETG/NUI Utilities funds were advanced to fund non-utility investments and cover non-utility losses. However, no detailed tracking of funds flow was possible at that time. There has been a recent, substantial reduction in the balance due NUI Utilities. It fell from $190 million at February 2003 to about $85 million by the time that NUI Cop. paid it off from the proceeds of the recent CSFB refinancing. The balance reductions over that time resulted from a host of general ledger entries. Some of the very largest entries, which are in the tens of millions of dollars, have no significant description beyond “other.” NUI has very recently provided some supporting details that described the balance changes, but Liberty has not yet been able to validate the reasonableness and propriety of the entries and the resulting, significant reduction in the receivable. Work to do so, which will require more information from NUI, continues.

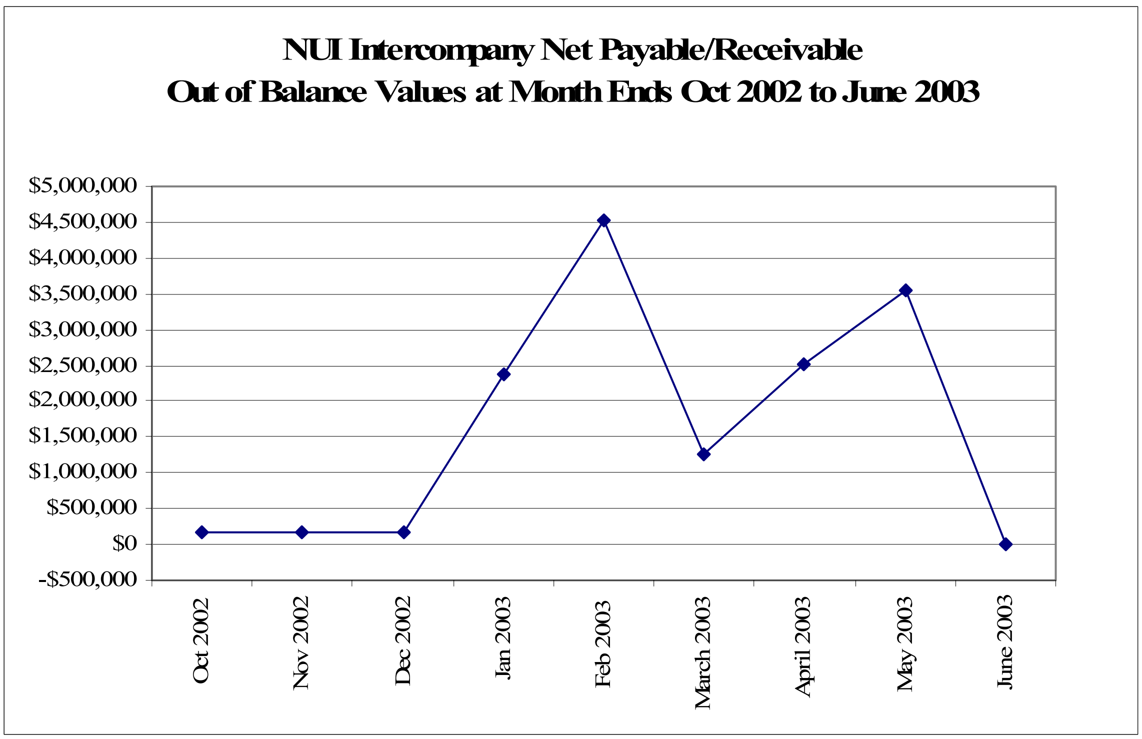
NUI does not account for much of the NUI Utilities receivable at the utility-division (*e.g.*, ETG) level. The failure to “push down” ETG’s share of the receivables balance impedes the ability to examine ETG’s condition on a stand-alone basis, which is the basis that the holding company order requires. Moreover, the Form 2 reports that ETG has filed with the BPU classified the receivables balances that are assigned to it as temporary cash investments, which they were not, instead of receivables, which they were.

[11] This sum is a gross amount for those entities only. The net amount owed to NUI Utilities was less, due to partially offsetting balances owed to other affiliates by NUI Utilities.

NUI also failed to provide for the regular settlement of these balances; *e.g.*, on a monthly basis, which is what Liberty's experience would suggest. The failure to settle them, assuming that there were the financial resources to do so, of course, is the primary reason why NUI finds itself with insufficient financial strength to provide for ETG's liquidity needs in a predictable, secure, and economical manner.

NUI's intercompany balances were also routinely out of balance. Liberty reviewed the sub-ledger balances for business units for fiscal 1997 through 2002 and for the 2003 fiscal year through June. NUI did not report or perform routine reconciliation (on a monthly or on any other regular basis) of the due-to/from among its business units. The accounts payable/receivable balances due to or from any given business unit should agree with a corresponding amounts for the other business units involved. The sum total of all intercompany balances when aggregated should "zero out," or cancel each other completely. Liberty's review demonstrated the monthly balances routinely were out of balance. The variances in some months approached $4 million dollars.

NUI has been reconciling intercompany balances monthly since June 2003, after which there have not been significant imbalances. The following table shows the trend in these imbalances for fiscal 2003.



The failure until recently to properly settle the intercompany balances on a routine basis and the lack of any formal policy or ability to make such payments had a negative impact on utility financial statements. This failure is reflected in the certified audit report prepared for NUI Utilities, Inc., on a standalone basis for the fiscal years ended September 30, 2001 and 2002. NUI's auditors, PricewaterhouseCoopers, chose not to reflect the $61.4 million of intercompany or associated accounts receivable due from NUI Corporation as an asset; instead they reflected it as a charge against (reducing) equity. The auditors' restatement of the receivable due from NUI Corporation has had a significant impact on the debt to equity ratio values of NUI Utilities, Inc. The total debt ratio increased from 54 to 60 percent due to this restatement of the $61.4 million as of September 30, 2002.

E. Accounts Payable and Receivable

NUI internal audits have, at least since 1999 found control weakness and failures to apply adequate polices and procedures to purchasing and accounts payable, to receipts, and to accounts receivable. Arthur Andersen, NUI's contracted internal and external auditor until June 2002, deemed a sizeable number of the findings of these earlier internal audit findings not to be material. NUI's current outside auditors, PricewaterhouseCoopers, have attached more significance to the negative findings about accounts payable and receivable. In particular, the new outside auditors found that many of the same weaknesses continued to exist in September of 2002. They determined that their findings of controls weaknesses, which included a number of accounts payable and receivable ones, were material.

Liberty's audit work has confirmed that NUI has taken programmatic steps to strengthen its internal controls for accounts payable and receivables. Draft updates to policies and procedures have been developed, but have not yet been finalized and approved.

F. Compensation and Benefits

NUI Corp. personnel perform the accounting functions related to payroll for all NUI business units. They use the PeopleSoft system to track payroll costs. Costs are adequately collected and reflected on the individual books of the business units. NUI's query functions within PeopleSoft provide a reasonable basis for extracting payroll cost by the business unit functions, including those cost that NUI allocates. Liberty found that NUI has used a reasonable and adequate accounting process for recording and collecting payroll data. There have been control weaknesses similar to those found in other accounting areas, but NUI is addressing them. NUI is in the process of updating its payroll internal controls to address the above issues identified. Liberty has examined recent, draft policies and procedures related to payroll. They appear to be sufficient to address prior, identified problems, but have not yet been finalized and approved by management.

G. Work Order Procedures & Continuing Property Records

NUI has adequate procedures for capitalizing assets and determining accounting lives. They are consistent with utility industry practice. However, there has been no examination of the fixed-asset or continuing-property-records functions since at least 1998. Such an audit should take place now.

Liberty found work order procedures to be adequate to support budgeting and tracking of costs. Moreover, NUI has applied them in a manner that provides for adequate definition of project costs at an appropriate level of detail. NUI also uses appropriate procedures for tracking construction work in progress (CWIP) costs, but did not implement them system-wide until May of 2003.

Liberty also found that NUI does not properly assign A&G overhead cost to the cost of construction. NUI's failure to do so has the effect of overstating A&G operating expenses, while understating plant asset values, accumulated reserves for depreciation, and annual depreciation expenses would be understated on the financial statements.

H. Joint Property

Liberty found only limited use of joint property among NUI affiliates. One case, the UBS use of customer billing equipment retired by 2000, is addressed in chapter three of this report. In another case, Liberty found that ETG for ratemaking purposes has placed into its rate base a share of the costs for shared customer service system assets that are on the books of the Florida utility operations (CGF) of NUI Utilities. Liberty has outstanding a data request to complete its review of this matter, but its work to date discloses no reason to believe that there has been any double counting or that ETG claimed a disproportionate share of the assets.

The principal instance of common asset use has been in the case of NUI Corp. shared overheads and support. NUI Corp. allocates the capital costs it incurs to provide those services as it does the people and other costs; *i.e.*, by applying the three-factor formula. Liberty addressed its concerns with the overuse of that factor in Section Three of its audit report.

I. Summary of Accounting and Controls Conclusions

1. NUI has adopted an accounting structure and an accounting separation that is generally appropriate; however, its treatment of intercompany accounts in regulatory financial statements is anomalous.

2. NUI's auditors' findings of duplicative accounts indicate a need for more rigor in assuring that account definitions and uses are sufficient to track costs with sufficient detail and distinction.

3. NUI business unit controllers reported to their business unit head until 2003; this approach represented a structural weakness.

4. NUI has failed to adopt and apply sound financial accounting policies and procedures in a number of areas; while NUI has addressed controls issues in a programmatic fashion, the creation of a comprehensive and well-structured set of written policies and procedures has not yet become a high priority.

5. ETG has not complied with the USofA reporting requirements in how it classifies and reports intercompany accounts payable/receivable transactions with associated or affiliated companies and has not accurately reported such activity on its FERC Form 2 annual reports.

6. NUI failed to follow good utility practice by failing to settle intercompany balances on a regular basis.

7. By not pushing down a proportionate share of the NUI Utilities receivable balance NUI failed to report financial information in a manner that adequately supports an examination of ETG's financial condition on a stand-alone basis.

8. NUI Corp.'s management of accounts payable and receivable affecting ETG have suffered from a persistent lack of controls, which NUI is now in the process of correcting.

9. The accounting process for recording and collecting payroll data are reasonable and adequate; NUI has been addressing controls weaknesses similar to those that have existed in other areas.

10. NUI's operating expenses are overstated because it fails to assign an A&G loader to construction costs.

11. NUI Utilities needs to conduct an audit of its fixed-asset and continuing-property-records systems, because such an examination has not been conducted for an extended period of time.

VI. Energy Affiliates

A. Background

ETG has had at least nine affiliates involved in energy operations. The ones with whom ETG has had significant interaction include NUI Energy and NUI Energy Brokers (NUI EB). ETG also shares certain services and costs with the other NUI LDCs: CGF in Florida, and Elkton in Maryland. In the energy area, those shared costs consist mostly of the costs of the gas supply planning function, which includes gas control.

NUI Energy was a retail energy marketing company, serving mostly commercial and a few industrial customers. Most of its customers were behind the city gates of its LDC affiliates, which included ETG. Customers bought gas from NUI Energy, rather than the LDCs, because NUI Energy offered pricing options not available from the LDCs. ETG treated NUI Energy on an arm's-length basis, as it did other third-party marketers. Substantially all of the retail accounts of NUI Energy were sold to an unrelated third party, effective July 1, 2003.

NUI EB is a wholesale energy marketer that provides wholesale trading, brokering, and risk-management services to affiliates and to unaffiliated customers and clients. NUI EB conducts the gas-supply operations of all of NUI's LDCs, acting as their agent. In this capacity, NUI EB buys much of their gas supply, and arranges for delivery of that supply, via transportation and storage capacity under contract to them, to their city gates.

NUI EB conducts the LDCs' gas-supply operations in the course of conducting its own marketing and trading operations. NUI EB estimates that physical gas-supply transactions for the LDCs represent about 15 percent of its total physical transactions. NUI EB also places the hedges for ETG's gas-cost stabilization (hedging) program. Those hedges represent about five percent of the trading in financial instruments that NUI EB identified for Liberty.

NUI EB also conducts the LDCs' secondary-market programs (off-system sales and capacity-release transactions). Finally, NUI EB has recently become a supplier of gas to the LDCs. The supply relationship occurs when NUI EB is a successful bidder in "reverse auctions" organized by the East Coast Natural Gas Cooperative (ECNGC, or "the Co-op"), a resource-sharing and gas-purchasing cooperative among several mid-Atlantic LDCs. NUI participates in the Co-op through NUI EB.

NUI Utilities, of which ETG is a division, buys gas in three ways:

- It has one remaining long-term purchase contract with a third-party supplier, although arrangements of that type are being allowed to expire without being replaced
- It puts seasonal and a portion of monthly requirements out for bid through the Co-op (administered by NUI EB)[12]
- NUI EB buys all monthly requirements (not awarded through Co-op bidding) and all requirements for daily supplies.

The proportion bought in the third way, *i.e.*, NUI EB acting as agent for ETG, has been in a range of 60 to 70 percent of ETG's total for the past five years. The proportion for CGF is higher, generally in excess of 90 percent. The utility divisions together buy about 25 percent of their total supply in daily spot markets. By inference, the proportion of the LDCs' supply bought in monthly spot markets is 35 to 45 percent for ETG, and over 65 percent for CGF. [13]

NUI Utilities personnel told Liberty that the custom was to make purchases through the co-op when at least three bidders made offers. The same personnel later told Liberty that there were significant numbers of exceptions; *i.e.*, NUI Utilities made no co-op purchases even though the requisite number of bidders responded. In these cases, NUI Utilities pursued its other principal means of purchasing gas, which was to have NUI EB make purchases for NUI Utilities in the spot markets. Liberty asked on November 6, 2003 (data request 651) for copies of all solicitations and responses to co-op administered bids for NUI Utilities and for information reflecting what actions NUI Utilities took in response to each. Despite repeated requests for a response to the request, which had a

[12] Liberty was initially told that all monthly requirements were secured this way, but after discovering that some are not, learned that NUI Utilities has solicited bids through the co-op, but made subsequent, unbid purchases on a number of occasions, perhaps from or through NUI EB directly, rather than as the co-op bid administrator. Liberty is now examining the reasons for using this procedure.

[13] NUI Utilities has very recently advised Liberty that these purchases include gas purchased to make off-system, cost-offsetting use of NUI Utilities' transportation assets, which makes them overstated as an indicator of the amount of daily gas used to serve NUI Utilities retail customers. Liberty is awaiting a promised supplement to a data request response to examine this matter further.

November 13, 2003 due date, NUI Utilities has not provided that information as of the date of this report. Therefore, Liberty has been unable to determine whether the Company used these exceptions to provide favored treatment to NUI EB.

Each LDC has its own gas-supply portfolio, including gas-purchase contracts and contracts for pipeline and storage capacity. NUI EB also has its own portfolio, consisting mostly of supply-pooling contracts, a few storage contracts, and contracts for interruptible transportation capacity.

A common Energy Management System (EMS) tracks gas-supply transactions for all affiliates and for NUI EB's third-party (*i.e.*, unaffiliated) customers and clients. EMS captures the details of all gas purchases and sales from inception through payment or receipt. NUI EB developed EMS, and operates and maintains it.

B. NUI Utilities Relationships with NUI Energy and NUI EB

The relationship between NUI Energy and the LDCs has generally been conducted at arm's length, recognizing the state regulatory frameworks that apply to that relationship. Liberty found generally that NUI Utilities treated NUI Energy as it would any other, third-party energy supplier. Liberty's work was not detailed, however, because this relationship was recently examined in the last competitive-service audit. Liberty does not intend its general conclusion to contradict any more detailed findings and conclusions of that other, recent audit.

However, because NUI EB does not operate at retail (its customers, including ETG, are wholesale customers), there was no similar, detailed competitive-services audit examination of ETG's relationship with NUI EB. Liberty did examine this relationship in detail. Liberty found the relationship between NUI EB and the LDCs not to have been at arm's length.

NUI Utilities' director of energy planning and his staff work at NUI's Bedminster offices, which are located in the same building as NUI EB's offices. Five persons paid by and nominally assigned to NUI Utilities conduct work for NUI EB. They work as an unsegregated part of a larger NUI EB complement that performs certain common functions for all of NUI EB's affiliates, asset-management clients, and other customers. These NUI Utilities personnel perform nominations and tracking and "back-office" functions required for gas-supply operations. This arrangement is informal; it has been adopted to provide a means for apportioning the costs of functions performed in common for NUI Utilities and for other NUI EB operations.

NUI EB employed for most of fiscal 2003 some 16 people that serve NUI EB and NUI Utilities functions in common. As a result, NUI Utilities bears almost one-fourth of the costs of personnel who work in common at NUI EB to serve NUI EB and NUI Utilities interests. NUI EB does not charge NUI Utilities any costs for access to EMS. NUI EB does not pay NUI Utilities anything for the value that comes to NUI EB through its relationship to NUI Utilities.

Substantial value is generally recognized as coming to an affiliated energy marketer and trader from such a relationship. Liberty would expect in fact an assignment of no economic value to NUI EB on a stand-alone basis in an effort to identify the proceeds likely to result from sales of all or parts of NUI businesses and assets. NUI EB also has had considerable discretion in its use of ETG's gas-supply assets; *e.g.*, in re-routing gas among ETG's gate stations. NUI EB also uses and pays for storage capacity on the Transco system, which capacity is under contract to ETG, but is surplus to ETG's requirements.

NUI has observed that the most recent competitive-services auditor considered the provision of services from the 16 NUI EB personnel to represent a cross subsidization in favor of the utility. When all of the relationships and lack of direct charges are aggregated, however, it is clear that any cross-subsidization runs strongly in the other direction.

The relationship between NUI EB and ETG is governed by an agency agreement between them. NUI EB performs the same functions for CGF and Elkton, but no contract covers those relationships. The agency agreement authorizes NUI EB to conduct ETG's gas-supply activities, but specifies no substantial performance requirements.

NUI Utilities uses winter and summer supply plans and monthly set-up meetings to establish requirements that frame NUI EB's buying and selling activities for the benefit of utility operations. There are, however, no policies and procedures that provide meaningful guidance on how NUI EB is to conduct these activities from a process or duty-of-care perspective. NUI Utilities has issued some guidelines for secondary-market activities, but those guidelines only address broad principles involved in defining opportunities for off-system sales or capacity-release transactions. NUI EB employs some informal practices for the conduct of the LDCs' supply operations, such as assigning individual transactions to one of the LDCs if that transaction involves an asset owned by or under contract to that LDC.

Having NUI EB conduct the LDCs' secondary-market programs creates significant structural conflicts of interest. These conflicts arise in part because ETG is permitted by the NJBPU to share with NUI EB only a small portion of any margins made from utility secondary-market transactions. NUI EB keeps only 15 percent of that margin in New Jersey; the remainder of the margins offset BGSS costs paid by customers of ETG, whose resources were used in making the sale. If NUI EB makes a sale for its own account, however, it keeps the entire margin for itself. NUI EB reported that the trader who makes the sale is the person who determines the particular client whose account gets credited with each sale. Liberty found a lack of effective and applied controls on the traders' designations of trade parties, such as deciding between NUI EB and the LDCs.

As noted earlier, NUI EB has more recently become a larger supplier of gas to the LDCs, by making winning bids in the supply auctions organized by the Co-op. NUI EB's success in competing for part of the LDCs' business has come since NUI EB took over Co-op operations. Given the NUI EB role in administering Co-op auctions, it is reasonable to conclude that possible access to their pricing and other information by NUI EB, a competitor, tends to discourage other suppliers from bidding.

C. Assessing the NUI EB/NUI Utilities Relationship

Liberty found only informal and indirect assessment by NUI Utilities of NUI EB's performance. ETG annually compares the rate in its BGSS filing with those of the other New Jersey LDCs, but has not inquired further, after finding ETG's rate competitive. NUI Utilities' director of energy planning also checks the prices that his LDCs are paying for gas against published indexes, but again has found no anomalies that led him to further inquiry. Liberty believes that NUI EB's conduct of NUI Utilities' gas-supply operations clearly invites questions on the part of NUI Utilities, but Liberty could find no analyses or evaluations of these or any other aspects of NUI EB's activities on the LDCs' behalf.

Liberty compared certain aspects of ETG/NUI EB activities against those of New Jersey's other two, gas-only LDCs. Liberty found that ETG's supply-capacity portfolio was within a reasonable range. Liberty also compared ETG's secondary-market activities with those of the other New Jersey LDCs. In this comparison, Liberty found that the level of secondary-market transactions, relative to the available capacity, is much higher for New Jersey Natural Gas than for ETG. The companies' gas-supply portfolios are not the same; therefore, their opportunities for secondary-market transactions are not the same. Nevertheless, the information available provides a general indication that New Jersey Natural is more aggressive than ETG in its secondary-market program. Liberty's qualitative observations about NUI EB's activities to date corroborate a lack of strong focus on maximizing returns to ETG from secondary-market activities.

Liberty also found that certain aspects of ETG supply activities seemed designed to accommodate NUI EB's activities and interests. For example, ETG allows NUI EB to shift deliveries of gas for ETG's customers among ETG's city gates when load conditions permit. This discretion allows NUI EB to take advantage of differences in gas prices and load conditions among the pipelines that deliver to ETG's city gates. Liberty found no evidence that ETG has evaluated:

- The benefits that NUI EB gains from having this discretion
- ETG customer costs incurred by allowing the displacement
- What compensation may be appropriate.

D. Analysis of NUI EB Transactions for ETG

Liberty conducted a preliminary examination of NUI EB's transaction records, in order to see whether patterns in the data suggested that structural conflicts of interest influenced NUI EB's behavior. Liberty created a sample of gas sales transactions, occurring on the same date and at the same delivery locations, in order to see whether there was a difference between those made for ETG's account and those made for NUI EB's account.

Liberty found that, for short-term sales made on the same dates and at the same delivery points, NUI EB fairly consistently received a higher price for its own gas sales than it received for sales of gas for ETG's account. Liberty discussed this pattern with NUI Utilities' ETG's director of energy planning. He was unaware that the pattern existed, but could think of no reason why ETG's gas should commonly bring a lower price. Liberty has no explanation either. He also said that the discovery of such a pattern was beyond the information available to him, because NUI EB did not allow him access to data for transactions, which EMS stores, other than those for NUI Utilities.[14]

The NUI EB representatives presented several possible explanations, which appeared to address variables that would produce relatively lower prices as frequently as they would produce relatively higher prices. Moreover, the principal explanation offered was contradicted by the documents NUI EB traders make contemporaneously with transactions, in order to record transaction details.

Liberty approached the NUI Controller to seek assistance in securing the underlying documents for later, more detailed review. He decided to contact their outside auditor, PricewaterhouseCoopers, and NUI has since decided to initiate its own examinations.

The information presently available to Liberty confirms the existence of a pattern under which common (as to commitment date, delivery date, and delivery location) sales by NUI EB for NUI Utilities and for itself brought higher prices to NUI EB. Overall sales (*i.e.*, not just those in common) show a similar leaning. There is also substantial evidence of a failure of controls in assuring that information about transactions was being contemporaneously recorded and protected against after-the-fact alteration. The information now available gives substantial reason to be concerned that observed price differences may have arisen from three factors inconsistent with good utility practice:

- An intention to steer higher priced sales deliberately from NUI Utilities to NUI EB both before and after sales were made
- Substantially lesser NUI EB attention to NUI Utilities sales because they produced very small margins in comparison to those available on sales for NUI EB's own account
- Sales, sometimes indirect, from ETG to NUI EB, which then made subsequent sales to a third party, rather than direct ETG sales to the third party.

Liberty has experienced a hiatus of six weeks while awaiting PricewaterhouseCoopers' work and is now preparing to resume its examination of these issues. Pending completion of Liberty's examination, the preceding report of observations and quantifications to date must be considered to be preliminary and subject to significant change, as facts develop and analysis proceeds.

[14] NUI Utilities personnel place significant reliance upon the fact that third-party asset managers do not allow their LDC customers to see what transactions they make with third parties either. This reliance is not well-placed; those asset managers make substantial payments to the LDCs for the kinds of access that NUI EB got. Those payments, which NUI EB did not make, are in lieu of compensation based on specific transactions.

E. Credit Issues

The general subjects of NUI's financial structure and credit are covered elsewhere in this report. The examination in this task area focused on the effect of NUI's financial problems and credit downgrades on ETG's relationships with gas-market counterparties, and the consequences of those relationships for gas-supply operations.

Down-grades in NUI Utilities' credit rating permit suppliers to require payment in advance for gas supplies. . The Company reported that it maintains standard form gas-supply contracts with over 100 suppliers, of which it is normally doing business with about 25 at any one time. The Company's policy is not to provide additional security; rather, it seeks other suppliers who will continue to do business on normal payment terms. In all types of credit transactions, which ETG gas purchases involve in the absence of collateral or prepayment, it is common for vendors to charge, at least implicitly, for higher credit risks. It is also common to charge for the time value of money, but, in the absence of deferrals beyond the normal once per month settlements, that factor is already built into all prices. Most of ETG's transactions did not contain unusual settlement provisions; however, as this report discusses, there have been three notable exceptions under which ETG has secured storage gas under deferred payment arrangements.

NUI Utilities' used short-term credit lines to finance gas purchases for storage injection through the summer and into the fall prior to 2001. Available credit, however, was already largely drawn down by late June of this year. In the face of this unusual lack of credit capacity, the Company negotiated two supply contracts that provide for gas deliveries during this year's storage-injection season, but for payment later, as the stored gas is withdrawn. NUI Utilities also arranged for such deferred payments during the 2001 and2002 as well.

Entering the spring of 2001, NUI faced the prospect of insufficient credit capacity and liquidity to finance both its gas distribution and its expanding non-regulated businesses. The 2000/2001 winter heating season had been especially cold and expensive for ETG. It had to carry approximately $55 million of un-recovered gas costs from this winter until at least the next winter season. NUI Corp. then anticipated making major investments in Virginia Gas and TIC in early- to-mid 2001. In the spring of 2001, NUI Corp.'s committed lines of credit were $132.5 million and it had additional uncommitted, discretionary lines of credit of about $100 million. NUI Utilities did not have its own line of credit at this time.

NUI Corp.'s peak borrowing level for March 2001 was $174.7 million, meaning that it was already using all of the committed lines of credit and over $40 million of the discretionary lines. Even though already extended, NUI faced the prospect of significant additional financing needs for:

- Filling of ETG's gas storage during the months of April-October without current recovery of the expense
- The purchase of Virginia Gas
- The purchase of TIC.

NUI considered two alternatives for buying ETG storage gas at this time:

- Contracting for asset management services for the storage facilities and storage gas
- Buying storage gas with deferred payments.

NUI rejected the asset management option because it did not want to lose control of storage assets. NUI decided to explore financing for the purpose of filling of ETG's storage by requesting gas suppliers to defer the payment for the storage gas until the December-April period, when ETG would begin to realize heating-season revenues. The NUI COO/CFO and the general manager and vice president of NUI Utilities requested that the NUI Utilities gas supply manager make inquiries of suppliers about willingness to sell gas on a deferred-payment basis. The manager of gas supply in turn requested Energy Brokers to perform a telephone solicitation of gas suppliers to determine interest in such an arrangement. Energy Brokers determined that Enron, then NUI EB's largest trading counterparty, would be interested such an arrangement.

Negotiations with Enron began in late March, 2001. NUI and Enron initially agreed to a delivered price of $5.82/Dth for gas delivered in April, 2001. This one-month deal got gas flowing into storage, while arrangements for subsequent months remained to be negotiated. The factors and considerations in negotiating a fixed purchase price for all of the 2001 storage gas were as follows, according to NUI management:

- The first month of gas deliveries (April 2001) priced at $5.40/Dth
- Forward price NYMEX "strips" for May-October delivery priced at about $5.80/Dth
- Enron "adders" that would include interest for the payment deferral

NUI and Enron negotiated a fixed price of $5.82/Dth for all of the storage gas. NUI provided Liberty an analysis of the storage gas purchase; it was prepared in 2001. The analysis indicates that the fixed price contract for gas deliveries was $5.37/Dth for April deliveries, and $5.55/Dth for all May-October deliveries. The total for gas purchases was $47,320,760. In addition, NUI was to pay Enron $2,471,545 for interest for delaying the payments due. This payment reflects an annual interest rate of 10.49%. The total amount due to Enron was $49,792,305 on gas deliveries of 8,560,000 decatherms, for a total net cost of $5.82/Dth.

NUI then decided to swap Enron's fixed price of $5.82/MCF for all of the storage gas for a floating price based on NYMEX. By swapping a fixed price for floating, Enron would pay NUI if the actual floating price were below the agreed fixed price. NUI's manager of gas supply believed that gas prices would be coming down, which proved to be correct. As a result of this swap, Enron paid $15.96 million to NUI over the May-October period.

In effect, NUI Corp. raised $49.8 million in temporary financing from Enron:

- $33.84 million for storage gas at the actual NYMEX prices
- $15.96 million in payments due to the swap arrangement.

Without the storage gas financing, NUI Corp's capability to finance all of its utility needs and non-utility investment plans would have been at substantial risk during the summer of 2001; *i.e.*, even before reasonable contingencies to deal with a lag in customer receipts and the possibility of a harsh winter. Short-term debt would have reached $236 million in July 2001; even if all of the discretionary lines of credit were available to NUI, it would have exceeded its existing credit lines by about $3.5 million. Even with the $49.7 million of temporary financing from Enron and issuance of $60 million of Senior Notes by NUI Corp. in August 2001, NUI continued to experience credit capacity and liquidity problems in late 2001. Short-term debt outstanding reached $190 million in November 2001.

Enron was in extreme financial difficulty in late 2001, and was pressuring its counterparties to make payments for delivered gas. Enron asked for immediate payment from NUI, even though it struck a deal to defer payments until December-April and in return had to pay particularly high interest rates for that deferral. Coincidently, Enron owed Energy Brokers about $3.4 million at this time. NUI negotiated a settlement payment netting out all NUI obligations for a payment of $42.9 million to Enron on November 30, 2001. The settlement took into account the NUI Utilities payable to Enron and the NUI Energy Brokers receivable from Enron, along with other expenses and physical and forward deals.

The settlement with Enron effectively resulted in NUI EB's stepping into Enron's shoes; *i.e.,* NUI Utilities ended up paying all moneys remaining due to Enron (including the very high interest rate) to NUI EB. However, the $42.9 million settlement produced by NUI EB represented about $6.9 million less than this amount. NUI provided a settlement worksheet explaining the settlement amount. Some of the difference reflected amounts Enron owed to various NUI entities. The largest was NUI EB, but NUI Utilities was among them. Liberty cannot determine from the documentation the reasons for and the propriety of more than $1 million of the settlement, which amount NUI EB appears to have retained for itself, rather than passing along to NUI Utilities.

Liberty stressed to NUI the importance of securing that explanation in time for the issuance of a December 17, 2003 interim report. NUI scheduled an interview with the president of NUI EB for the morning of December 11, 2003. At roughly the close of business on December 10, 2003, NUI informed Liberty that the interview was cancelled because of concerns by the NUI EB president about who would accompany him to the interview. NUI offered December 17, 2003, the date of this report, as the earliest date for rescheduling the interview. Therefore, Liberty remains without explanation of the reasons why NUI EB retained for itself substantial sums under a settlement of mutual obligations, whose predominant portion was the payment obligation of ETG to Enron.[15]

With the payment of the settlement to Enron, NUI Corp. short-term borrowings outstanding reached $232.5 million, which consumed all of its committed and discretionary lines of credit. NUI also faced the expiration of its committed lines of

[15] NUI did inform Liberty, however, that the NUI EB president did have sufficient time to make (prior to December 17, 2003) a commitment of an entire day to its own firm's investigation of NUI EB's conduct.

credit in December 2001. Thus, NUI obviously faced substantial liquidity difficulties at this time. NUI chose to replace the $232.5 million in Corp. lines of credit with an $80 million revolver at Corp. and a $145 million revolver at Utilities. The Utilities revolver was immediately fully drawn down. As of the end of December 2001, NUI Corp. and the non-regulated entities owed NUI Utilities $40.1 million. This amount represented the first funding of non-utility businesses by NUI Utilities. NUI Corp. borrowings for the non-regulated businesses were replaced by Utilities borrowings, in an initial amount of about $40 million in December 2001.

The extent to which the NUI Utilities revolving line of credit was used to fund the NUI non-regulated activities grew greatly in 2002. In fact, during the period from March 2002 through June 2003, the Utilities revolver with the Fleet bank group was used predominantly to finance the inter-company receivable balance from NUI Corp., which was in turn invested in the non-regulated activities, Deferring ETG gas payments as a financing mechanism also occurred in 2002 and 2003, at somewhat reduced levels. NUI Utilities had a $145 million revolver, but effectively could not use it because this revolver was being used to finance non-regulated businesses, as shown above. In both 2002 and 2003, ETG purchased storage gas from Occidental with deferred payment arrangements, although in lesser volumes than in 2001.

Debt-rating agencies have required that NUI Utilities' cash flow and credit be segregated from those of the other affiliates as a condition of upgrading the LDCs' debt. This segregation has enabled gas-trading counter-parties to distinguish between NUI Utilities and NUI EB. Many more of them have declined to continue doing business with NUI EB than is the case with NUI Utilities. To the extent that NUI EB and NUI Utilities have had differential costs of money over time and that suppliers have not been able to distinguish between the two, NUI EB has been supported by NUI Utilities in any case where it has had the benefit of association with a less risky entity, such as NUI Utilities.

F. Asset Management

Since at least early 2001, the Company has seen its "Energy Hub Strategy" as central to its growth prospects. In view of this focus, Liberty examined whether, and how, ETG's relationships with its energy affiliates might have affected the nature and availability of resources for the utility.

Liberty found that the LDCs have generally been seen as essential to the strategy, and thus have generally been provided with adequate resources of personnel and capital to conduct their business. Liberty has some questions about unusual accommodation of the affiliates' interests, in addition to concerns about the consequences of the relationships for the utilities' cost of credit, but generally found the LDCs to be adequately staffed and adequately maintained. Liberty's concern is whether the LDCs are realizing the full value of their gas-supply assets when they allow NUI EB to conduct their secondary-market programs.

Some LDCs in other states contract out management of their gas-supply assets to third-party asset managers. By contracting out their assets, LDCs have often received more than the margins that they would generate through conducting their own secondary-market programs, because the external asset manager is willing to pay a share of the extra margins that it can earn for control of a larger portfolio of assets. Liberty's view is that NUI Utilities should require competition for the right to manage its assets, even if it allows its affiliate NUI EB to compete.

G. NUI EB Audit Cooperation

NUI EB failed on a number of occasions during this audit to:

- Conduct itself in compliance with the holding company condition on information access
- Provide information necessary to meeting the scope of the audit
- Provide timely access to its senior management for interviews to address important audit issues.

Liberty also concluded that good utility practice, based upon its extensive experience in performing affiliates audits of utilities, required more than NUI EB was willing to offer. Examples include refusals to provide relevant information, a failure to support needs for assuring the integrity of data pending audit examination, and extensive delays in providing relevant information.

H. Summary of Energy Affiliate Conclusions

1. The NUI Utilities $145 million revolving line of credit has been used almost exclusively to fund NUI's non-regulated investments, operations and losses since March 2002; charging a risk premium on NUI Utilities loans (above the NUI Corp. blended rate actually used) to affiliates of 3 percent produces an amount due of $3.7 million, while a premium of 5 percent produces $6.3 million.

2. Utilities' 2001 purchase from Enron of storage gas with payment deferral inappropriately cost ETG excessive rates of interest; NUI Utilities' purchased gas costs included $3.5 million in excess interest costs: $2.5 million for the Enron deal, $0.4 million for the Occidental 2002 deal and $0.5 million for the Occidental 2003 deal. In addition, NUI has failed so far to account for NUI EB's retention of significant economic value from a settlement with Enron of ETG's payment obligations under that purchase.

3. NUI's financial problems have reduced the available number of gas suppliers to ETG and have exposed it to increased credit-related costs.

4. NUI EB derives substantial benefit from its relationship to NUI Utilities without having to undergo arm's-length bargaining for the right to have that relationship.

5. NUI Utilities has on at least several occasions made utility assets available to NUI EB without the benefit of an arm's-length, competitive process.

6. NUI EB has consistently produced higher prices for its own sales than it has for similar sales on behalf of ETG. There is as yet no apparent justification for the

difference, which, if it remains unsupported, has resulted in excess costs being recovered through BGSS. There are grounds for pursuing a detailed examination of the good faith with which NUI EB has conducted activities on behalf of ETG.

7. The controls that NUI EB applied to activities that it conducted for ETG failed broadly to meet good utility practice or to provide adequate separation between its assets and activities and those of ETG.

8. NUI Utilities has not acted effectively to assure itself that NUI EB's performance has been competitive and efficient.

9. NUI has provided contradictory information about co-op purchases administered by NUI EB, and has failed to provide the information necessary to allow Liberty to determine what adverse impacts, if any, have resulted from NUIEB's administration of co-op bidding processes for NUI Utilities..

10. By comparison with New Jersey's two other gas-only LDCs, NUI EB has produced significantly higher margins per dollar volume of business conducted.

11. NUI EB has not conducted transactions for utility operations with sufficient segregation and controls.

12. NUI EB's conduct during the course of Liberty's audit has not conformed to the information access requirements of the holding company order, to the scope of the audit, or to good utility practice.

13. Liberty found no reason to question the conclusion that ETG managed its relationship with NUI Energy at arm's length.

14. ETG had relatively little interaction with the other energy affiliates (the other LDCs, plus Virginia Gas).

15. NUI EB has not relied upon the resources of NUI Utilities through the common cash pool; it had a net intercompany receivable of $16.5 million as of June 30, 2003.

16. NUI Energy has relied upon the resources of NUI Utilities through the common cash pool; it had a net intercompany payable of $27.9 million and negative net worth of $10 million as of June 30, 2003.

17. NUI Energy Solutions has relied upon the resources of NUI Utilities through the common cash pool; it had a net intercompany payable of $700 thousand and negative net worth of $400 thousand as of June 30, 2003.

18. Virginia Gas has relied upon the resources of NUI Utilities through the common cash pool; it had a net intercompany payable of $54.9 million as of June 30, 2003.

19. NUI Saltville has relied upon the resources of NUI Utilities through the common cash pool; it had a net intercompany payable of $14.8 million as of June 30, 2003.

VII. Corporate Governance

A. Board of Directors

The NUI Corporate Board ("the Board") has consisted of seven directors, including two inside directors, the Chairman of the Board and the CEO, and five outside directors.[16] NUI Corporation has a number of subsidiary corporations and second-tier subsidiary corporations, almost all of which have their own boards of directors that consist of NUI management employees:

- NUI Capital Corporation, with subsidiary corporations NUI Energy Inc., NUI Energy Brokers, Inc., NUI Energy Solutions, Inc., NUI Environmental Group, Inc., NUI International, Inc. (under which are NUI/Caritrade, Inc. and NUI Hungary, Inc.), NUI Sales Management, Inc. (under which is T.I.C. Enterprises, LLC), NUI Service, Inc., NUI Telecom, Inc., and Utility Business Services, Inc.
- NUI Saltville Storage, Inc., under which is Saltville Gas Storage Co LLC and of which the company is a 50% Owner,
- NUI Storage, Inc., under which is NUI Richton Storage, Inc.
- NUI Utilities, Inc. (under which ETG, CGF, and Elkton operate as divisions, but not separate corporate entities)
- Virginia Gas Company, under which is Virginia Gas Distribution Company, Virginia Gas Pipeline Company, and Virginia Gas Storage Company.

B. Board and Committee Size, Structure and Composition

Liberty found that the NUI Corp. Board was small given the size of the workload, the scope of company business operations, the number of committees, and the frequency of meetings. Board members make a fairly substantial time commitment to NUI matters. In addition to Board membership, directors are typically members of three and even four committees, and four of the five outside directors chair a committee. The Board typically meets six times per year and committees typically two to three times per year. Board members estimated meeting length to be three to four hours on average and three to four hours of typical preparation time for each meeting.

The committee structure reflects a reasonable division of authority and responsibility for the various Board functions. Committees include Audit, Compensation, Executive, Investment, and Nominating and Governance, which present a fairly typical structure. Because of the small size of the Board, the Executive Committee, which includes all but one director, exists on paper but rarely, if ever, meets. A review of the committee activities indicates that there has been a focus on relevant matters.

[16] The departure of the CEO from the Company in late September 2003 reduced the board membership by one person.

The NUI Board has been characterized by very low turnover for many years. From 1998 to the present only two long-time directors left the Board. One reached mandatory retirement age (72), and retired from the Board in January 1999. The second resigned from the Board voluntarily in January 2002. In 1998 one director was added, which means there has been a net reduction of one person to an already small board. Moreover, the added person was the only candidate considered for the position. Historically, the company has handled succession planning for the Board and company executives on an *ad hoc* basis, without a formal succession plan or process. This is now changing, as described below.

The recently established Nominating and Governance Committee has had a heavy start-up workload, which is expected to continue for the next 12 to 24 months. The committee has instituted a self-assessment process for the Board and the committees, a director succession-planning process, and a Board member education and training requirement.

C. Board and Committee Processes and Procedures

Among the sitting directors, identification of candidates and the review process has been informal and undocumented. NUI has recently adopted formal, written guidelines and requirements for Board member selection. NUI has not had specific requirements or guidelines for specialized or general training or education needs, and has not offered such training. The company has recently developed draft guidelines for continuing education of directors.

Director attendance at Board and committee meetings is generally good. To the extent that members occasionally cannot attend in person, they generally attend by telephone. Board and committee members generally receive information packets from the CAO/General Counsel to prepare for meetings with sufficient time to allow adequate review of those materials. Advance time varies from several days to several weeks.

The retention of Board records has been deficient. There is no written policy on records retention. NUI does not routinely retain in an organized fashion those documents handed out at Board meetings. In addition, the Company was unable to produce certain reports and presentations that directors specifically requested be filed with the minutes.

The Board began a self-assessment process during 2003. Part of the process involves a survey of the directors, which provides valuable insights into what the Board thinks about itself, but offers no outside perspectives. The first survey has been administered and compiled, but has not yet been reviewed by the Board. The intention was to survey the Board annually and to extend the surveys to the committees next year.

The Audit Committee's practices and procedures were generally in keeping with the requirements or proposed requirements of Sarbanes-Oxley and the securities exchanges. The recently approved charter of the Audit Committee implements or formalizes many of those requirements. The recently created Nominating and Governance Committee implements another of the requirements of Sarbanes-Oxley. The Company's corporate governance guidelines have been developed.

D. Board and Executive Knowledge about and Focus on ETG

The Board has not focused on fulfilling its role with respect to the utility business or ETG in particular. NUI has not used the ETG Advisory Board effectively in this regard. These problems are exacerbated by the lack of utility operating and regulatory experience among the Board's independent directors. Two independent directors have gas or energy industry experience. They were long-standing acquaintances of the NUI chairman through the American Gas Association; however, their experience was not in gas utility operations or gas portfolio management. A telling example of this weakness is the lack of awareness of significant requirements of the BPU holding company order, described in the next section of this report.

While the outside directors are accomplished and have substantial experience in business and the public sector, Liberty did not find among the independent directors a strong understanding of key indicators and events in the natural gas industry and the utility business. Some NUI Corp. senior executives exhibited the same lack of knowledge.

The packages and handouts provided to the Board and its committees are limited, and do not present sufficient information and context for an in-depth understanding of the ETG business. The information provided about ETG in advance of the Board meetings is too general and brief. The oral reports and information provided at Board and committee meetings, as indicated in the meeting minutes, display the same lack of depth and scope. Further, discussions as reflected in minutes and presentations, as well as interviews, did not reflect an understanding of the relative importance of the various corporate entities.

E. Board Review of NUI Ventures

The Board has not had an effective mechanism for dealing with new ventures. The Chairman (and the other directors as well) did not appear to challenge management on the feasibility of new ventures, and did not institute a structured framework for evaluating, monitoring, and potentially terminating those ventures, despite the existence of broad expansion plans, aggressive actions to execute those plans, and significant failings of those actions to produce expected results. Further, the Board has not established firm go/no go decision points, and has not set milestones or exit strategies for new ventures being pursued.

F. Internal/External Auditor

The Company used the same firm as both internal and external auditor prior to the emergence of outside concerns about controls. For many years Arthur Andersen performed both functions. It was only as public awareness of auditor issues and conflicts came to the fore and as the exchanges raised the issue that the company began to question the practice. When NUI replaced Andersen it hired separate firms for the two roles.

Liberty would not conclude as a general rule that it was necessarily improper to use the same contracted firm for internal and external auditing at the time that NUI did so. However, one must consider the special circumstances at play here. There was a lack of internal resources at NUI to dedicate to oversight of auditing and controls issues. There was not strong senior management attention to controls issues. Non-utility operations spanned a wide range of business types and operating and financial risks, some of them potentially very large.

The introduction of the holding company order in early 2001 should have been viewed as a milestone event requiring the establishment of sound controls and financial separation. These factors taken together lead Liberty to conclude that NUI should have adopted a more conservative approach by retaining separate firms to perform internal and external auditing.

G. Compliance with the BPU Holding Company Order

On January 31, 2000, the company filed a request with the BPU for permission to form a PUHCA-exempt holding company to own all the outstanding stock of NUI. By order dated February 14, 2001, the BPU approved the petition subject to a number of conditions, including:

> *The assets of Elizabethtown Gas Company shall not be pledged to support any financing related to NUI Utilities' other divisions or its subsidiaries unless approved by the Board pursuant to N.J.S.A. 48:3-7.* [Order at 5, item 16]
>
> *There shall be no commingling of cash between NUI Utilities and NUI Capital. If NUI Capital shall fund operations, capital additions or investments by external borrowing, any such borrowing or commitments by NUI Capital or its subsidiaries must be non-recourse to NUI Utilities and may not provide for cross-default to, or for credit support from NUI Utilities, unless prior approval is granted by the Board.* [Ibid. at 6, item 24]

In interviews with Liberty, four of the five outside directors did not recall any briefing to the Board on the subject or conditions of the order, other than being notified that they had received holding company approval. The fifth director remembered some type of discussion about the order but not the specifics. All five stated that they learned of the specific requirements with respect to the commingling of cash and the intercompany balances from the PricewaterhouseCoopers audit. They stated their reactions to learning they were out of compliance with the Order. The comments show lack of common understanding about the existence of the intercompany balances before the PricewaterhouseCoopers audit, disagreement about the significance of the audit in the context of holding company order compliance, and even different recollections about whether management had ever even informed them of the order's requirements as they affected NUI's overall structure and operations. Their comments to Liberty were as follows:

- (Outside Director One) Up until the change of auditor, he/she did not know that commingling of cash was an issue. The Board knew there was one cash "bucket," but not that it was inappropriate. Commingling was consistent with what other holding companies did. As soon as it was identified as a problem, the Board took immediate action. He/she believes that NUI has not violated the holding company order.

- (Outside Director Two) He/she was not aware of the existence of cash commingling, nor of the significance of the issue. He/she relied upon Arthur Andersen to be on top of issues of that kind; they did not identify its existence. When PricewaterhouseCoopers brought it up, his/her reaction was to make the change immediately. The holding company order made commingling improper and it should have clear all along to those on whom he/she thought the Board was relying. He/she had no idea that the existence of the intercompany balances was a problem.
- (Outside Director Three) He/she first became aware of the intercompany balance issue following the PricewaterhouseCoopers audit. His/her reaction was to question how this could have happened. He/she was stunned to learn of the problem.
- (Outside Director Four) The Board had several reviews with management specifying what was required by the BPU holding company order; there would have been a presentation by management about it. He/she did not study the BPU order, and no one has ever taken him/her through it. He/she relied upon management to tell him/her what was in it. The Company would not challenge the BPU's belief that commingling violated the order. If he/she had known they were in violation, they would have changed things. He/she would have expected Arthur Andersen to identify issues or problems to the chair of the Audit Committee. He/she was aware they had a single cash pool; they thought that was acceptable. They depended heavily on Arthur Andersen. When it became clear that this was not acceptable, they instituted the changes.
- (Outside Director Five) With respect to commingling of cash, he/she has not reached the conclusion that they were in violation of the holding company order. As he/she understands it, what NUI did with respect to commingling was consistent with the order. He/she thinks they have been meticulous in complying with the holding company order. They were not adequately informed about the intercompany balances. They directed management to fix it. The existence of those balances was significant, but did not have any effect on the utility.

Liberty has concluded that there were several high level corporate failures with respect to the foregoing issues surrounding compliance with the Holding Company Order:

- Management clearly ignored key terms of the Holding Company Order. It is difficult to comprehend how anyone could read its provisions and not come away with a clear understanding of several prohibited activities.
- The NUI Board has operated without a sound understanding of the Holding Company Order and without requiring a structured process for overseeing compliance efforts. The Board failed to require management to adequately explain the order's requirements or to institute reasonable measures for assuring continuing compliance with the order.

- To the extent that the Board may have been briefed on the Order, it appears that the conditions above were never mentioned. Liberty notes that no briefing documents have been produced by the company, there is no record of discussion of the order or its terms, and only one outside director believed that there had been a review of the order by management. Further, the statements of the directors indicate that they did not have even a basic knowledge or understanding of the requirements of the order.

The company's official position is that it has been in full compliance with the holding-company order at all times since its issuance. Its general counsel filed in April 2003 a letter so stating, and he repeated the claim, not when Liberty was interviewing him, but at a point when Liberty was trying to determine a director's personal views on the matter.[17]

H. Summary of Corporate Governance Conclusions

1. The Board is too small given its workload.

2. Board members make a substantial time commitment to NUI matters and attendance has been good.

3. The Board has not fulfilled its responsibility to the utility business generally or ETG in particular, nor has the ETG Advisory Board been used effectively.

4. Board members and NUI Corp. executives displayed insufficient knowledge of the gas-utility business in Liberty's interviews.

5. The Board committee structure reasonably divides authority and responsibility for the various functions.

6. NUI Corp. took substantial and timely actions to implement new stock-exchange and statutory governance requirements.

7. The NUI Board had little turnover for many years, and until recently had no process for identifying new director candidates.

8. Until recently NUI had no requirements for director training, didn't offer such training, and handled succession planning for directors on an *ad hoc* basis.

9. Board members receive information packets to prepare for meetings with sufficient time to allow adequate preparation but the packages did not present sufficient information for an understanding of the ETG business.

[17] Under protocols established for this audit, interview monitors, which was the role being filled by the general counsel, were present for notetaking, and therefore not to offer unsolicited answers to auditor interview questions.

10. The Board has not had an effective mechanism for evaluating expenditures for non-utility businesses and did not challenge management on the feasibility of new businesses nor have a process for evaluating and monitoring them.

11. The outside directors are accomplished and have substantial experience in business and the public sector.

12. The Company's use of the same firm as both internal and external auditor was not appropriate.

VIII. Compensation of Executives and Directors

A. Establishment of Compensation

The Compensation Committee of the Board of Directors sets NUI policies for executive and director compensation. As currently constituted by charter created in November 2002, the committee consists of three or more independent directors selected annually by the Board. NUI's consultant on executive and director compensation, Pearl Meyer & Partners (PM&P) reported to this committee.

The committee has been meeting a minimum of three times per year in recent years:

- September, when it establishes an executive compensation plan and levels for the coming calendar year
- May, when it considers mid-year compensation revisions
- November, when it examines executive incentives which may have been earned the preceding year.

NUI uses a three-factor formula (it consists of the simple average of each entity's labor, plant, and customers) to allocate the costs of compensation for executives who serve multiple business units, including the CEO, the COO/CFO, the general counsel/chief administrative officer, and the treasurer.[18] ETG represents somewhat more than 60 percent of NUI under this formula; there are small variations from year-to-year as these three factors change at each subsidiary. ETG therefore bears about two-thirds of the costs that NUI allocates by using this formula.

Executive compensation at NUI includes the following elements:

- Base salary
- An annual cash incentive award, payable for and varying with performance during a given fiscal year
- Grants of restricted stock, which may be converted contingent upon the Company meeting certain performance goals
- Long-term incentive awards consisting of two parts: a cash award that pays out if the Company performs in an exceptional manner, and stock options which vest after 2004 if the executive stays on as an NUI employee.

[18] Chapter three of this report addresses NUI's use of that factor in more detail.

Liberty concluded that the structure and administration of executive compensation have been reasonable. The overall structure (separate from the size of the components) of the compensation packages is reasonably comparable to those of similar utility companies.

B. Compensation Levels

NUI has used an inappropriate market against which to compare its executive compensation. The result has been unjustifiably large increases in base salary. PM&P recommended, and NUI agreed, that the peer group against which NUI should be compared was diversified energy companies, rather than gas distribution utilities. In effect, it used a peer group of companies of the type that NUI was seeking to become, but not of the type that it represented at the time and remains today. NUI raised the compensation for its executives substantially in 2002, relying upon this faulty comparison base. Liberty believes that the compensation prior to those raises was at a reasonable level; it compared favorably with the levels of two other New Jersey LDCs, South Jersey Industries (SJI) and New Jersey Resources Corporation (NJR). In 2002, however, total reported NUI CEO compensation was at $1.07 million, which far exceeded the $684,000 and $662,000 at SJI and NJR, respectively. These totals include SEC-reported values of restricted stock grants, which may differ from what eventually became vested.

C. Incentive Compensation

NUI did not hold to established, communicated incentives when it failed in some years to meet relevant financial goals. The Company has not made long-term incentive program payments recently, because its financial performance did not warrant it. That portion of its incentive compensation plan has operated as designed and communicated. In 2001, however, when the CEO did not qualify to have restricted shares of stock vest, the Board awarded him an additional cash bonus. In 2002, the Board overrode the program again when it attributed ineligibility for payouts to warmer than normal weather. Yet again, in 2003 the Company made two special grants of restricted stock, even as the Company's financial condition continued to deteriorate.

The measures used to determine payouts to executives under the incentive compensation program have little to do with ETG or utility group performance, even though ETG represents, as the Company measures it for cost allocation purposes, almost two-thirds of the Company. Unlike the non-utility subsidiaries, ETG operates under the special restrictions and the high public expectations reserved for utility service providers. With one minor exception, the incentives all relate to corporate or subsidiary financial performance.

D. Director Compensation

Director compensation is higher than it should be. NUI's directors are paid at the top of the relevant comparable market. In particular, the directors' packages exceed those of SJI and NJR.

The compensation package for the ETG advisory board is too low to compensate them for the time it should reasonably take to fulfill their responsibilities, assuming that it is vested with more substantial authority than it has had to date.

The consulting agreement with the Chairman of the Board has become unsupportable. There may have been merit to some type of arrangement when he first retired; this particular agreement has, however, remained in place for too long. The initial contract was for three years. It has been renewed twice for a total of nine years; it currently costs more than $300,000 per year.

E. Corporate Compensation Policies

NUI distributes compensation costs for executives providing common services by the three-part allocator. This approach unduly burdens ETG. ETG has also borne an unfair portion of the cost of director compensation and a disproportionate share of the costs of the compensation consultants for the same reason. The three-part allocator assigns more than half of the costs to ETG. This approach is not reflective of the amount of time the executives and directors spend on ETG.

Paying directors in stock instead of cash is well-intentioned, but could cause problems in attracting new candidates. Its strength is that it aligns director interests directly with shareholder interests. However, it may discourage candidates from joining the Board because it defers much of their compensation until they retire or resign from the Board.

NUI's policy of requiring directors and executives to own a specified minimum amount of Company common stock is desirable, because it helps to align the interests of the directors and executives with the stockholders and customers.

NUI's change-in-control agreements are a standard feature of the relationships between corporations and their officers. Such agreements seek to motivate the officers to work in the best interests of the shareholders in the event of a prospective takeover or merger.

F. Summary of Executive and Director Compensation Conclusions

1. The structure and administration of executive compensation have been reasonable; the change-in-control agreements are a standard feature of the relationships between corporations and their officers.

2. NUI has used an inappropriate market against which to compare executive and director compensation, resulting in raises in base salary that were too large.

3. The consulting agreement with the chairman of the board is unreasonable.

4. The compensation of the members of ETG's advisory board is too low.

5. The requirement of having directors and executives own a minimum amount of the common stock of the Company is a desirable policy because it helps assure that the interests of executives is in line with that of stockholders and customers; the policy of

paying directors in stock instead of cash may be well-intentioned, but could cause problems in attracting new directors.

6. NUI paid some executive incentives even when the Company's financial performance did not meet goals; the measures that NUI uses in determining whether executives should be awarded payouts under the Company's incentive compensation program have little to do with utility performance.

7. ETG bears too much of the costs of executives and of the costs of consultants on executive compensation.

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[i] Response to DR 670.
[ii] Response to DR 679.